

TAKAFUL AND CONVENTIONAL INSURANCE IN MALAYSIA: AN OVERVIEW

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Abstract

In this paper the status of *takaful* and insurance in *shari'ah* and their operational mode were examined. To arrive at these findings and the discussions in this paper, reference was made to papers presented at various Islamic finance conferences, views and fatwas made by Islamic scholars and to some extent the sayings of Allah (S.W.T) and Prophet Muhammad (s.a.w) as carried in the *Qur'an* and *Hadith*, respectively. The basic concept of both *takaful* and insurance are viewed by many scholars as the same, in that the main objectives of both is that of providing protection against loss of properties and livelihood explained in Islam as '*ikhtiar*'. It is unanimously agreed that the differences between the two forms of insurance is the mode of operating them. While *takaful* is based on *Shari'ah* compliant principles for example paying premiums on the basis of *tabarru* and devoid of interest, it was identified that conventional insurance contains 3 *Shari'ah* non-compliant elements namely; *gharar* (uncertainty), *riba* (interest) and *maysir* (gambling) which makes it unlawful in *Shari'ah*. The differences in the operational modes of the two are highlighted and the conflicting points of conventional insurance with the *Shari'ah* are addressed.

Keywords Takaful, insurance, Shari'ah compliance, operational models.

Introduction

People from the times of history are aware of the risks that are associated with life and business transactions. People always thrive to minimize these risks and to assure themselves of a way to get relieved in cases of lost of livelihood or possessions. This generally brings about the concept of insurance, which exists in our world from olden times. During those times merchants used to transport their cargo in ships across the seas to other countries and as such are faced with many risks of lost due to piracy and sinking ships. Muslims traders particularly will contribute little at a time and who draws the lot gets the full amount. This was a good example of savings. Whenever a trader would suffer an accident, then the unfortunate trader would be compensated using this fund so that he could recoup his loss and find his bearings again and establish back his business (1). This is the old method of insurance. In the last two decades the

new concept of Islamic insurance with the name of *Takaful* has become known and is progressing in different countries of the world including Islamic and Non-Islamic countries.

Definitions

a. Insurance:

Insurance is a risk transfer mechanism whereby the individual or the business enterprise can shift some of the uncertainties of life on the shoulder of the other (2). Insurance provides the means for people to transfer the burden of uncertainty of financial loss to the insurer, for an agreed financial consideration called the “premium”. In exchange, the insurer promises to provide financial compensation to the insured should a specified loss occur. It is an effective risk transfer mechanism by which individuals or organisations can exchange their uncertainty of financial loss (or risk) for the certainty of the premium. With a fixed premium, the insured is certain that he will not have to pay more for that year. This service of providing certainty of cost (fixed premium) is of immense value especially to organisations, as it would help them budget their expenditure confidently. This is the financial security provided by modern insurance. In peace the insurance provides protection to trade and industry, which ultimately contributes towards human progress. Thus insurance is the most lending force contributing towards economic, social and technological progress of man.

b. Takaful:

Takaful is derived from the Arabic root-word “*kafala*”, which means guarantee, bail, warrant or an act of securing one’s need. Therefore *takaful* (in its reciprocal form) means joint guarantee, whereby a group of participants agree to mutually guarantee each other against a defined loss (3). The central idea of Takaful (Islamic insurance) contract is that it is a financial transaction of a mutual co-operation between two parties to protect one of them from unexpected future material risk. In a Takaful transaction, the party called the participant (insured) pays a particular amount of money known as the contribution (premium) to the another known as Takaful operator (insurer) with a mutual agreement that the insurer is under a legal responsibility to provide the participant with a financial protection against unexpected loss, should it happens within the agreed period. However, in a case whereby the loss does not occur against the insured within the specified period, the insured is entitled for the whole amount of paid-premiums together with the share of profits made out of the cumulated paid-premiums based on the principle of *al-Mudharabah* financing technique. In such a transaction, both the insurer and the insured are mutually helping each other for financial protection.

Having mentioned the definitions of conventional and *takaful* as above, it is easy for one to see that the two have the same aim and are similar in the objective that are set to achieve, which is that of providing a protection for individuals or businesses in cases of loss. In fact, the act of taking precautionary measures or ‘*ikhtiar*’ against possible danger and its consequences is in line with the teachings of Islam. In the holy Quran it is clearly described how Prophet Yussof (a.s) filled the grain silos from the surplus of seven years of good harvest as a protection to ensure the availability of continuous

food during the seven lean years. This is a clear indication that one has to strive hard to avoid from being inflicted by any ill luck, and at the same time be fully prepared in terms of the measures taken as precautions in the event such an unfortunately eventuality cannot be avoided. One such measure available to every member of the community presently is the cover or protection provided by insurance policies. As a concept, insurance actually does not contradict the teachings of Islam, as it is a method by way common resources are pooled in order to help the needy. Based on this, it is said that the operation of insurance as known today was established on the practice of blood money under the Arab tribal custom, which formed the basis of modern-day mutual insurance (3). In Asia, the practice of insurance was first established in the early second century of Islamic era when Muslim Arabs began to expand their trade to India, Malay Archipelago and other Asian countries. Because of the long distance, the voyage was hazardous and the traders often had to incur losses arising from a multitude of misfortunes. However despite having the same noble and Islamic objective of providing protection and coverage to the policy holders, conventional insurance suffers from fundamental problems in its modus operandi, mainly due to the occurrence of *shari'ah* non-compliant elements i.e. *gharar* (uncertainty), *riba* (interest) and *maysir* (gambling). Due to this reasons *takaful* was introduced to offer an Islamic and Shari'ah compliant alternative to the conventional insurance. Currently *takaful* has become a growing and fast developing industry. The purpose of this paper is to discuss the concept of *takaful* and its *shari'ah* basis compare it with those of conventional insurance and to try answer the questions many muslims are asking why *takaful* and not conventional insurance?

Origin and Evolution of Takaful

Under Islamic law, the contemporary *Takaful* practices in fact, originated from the ancient Arab tribal custom of *al-'Aqilah*. The doctrine of *al-'Aqilah* used to be practiced based on a mutual agreement among the ancient Arab tribes. It was a common practice among the tribes that, if any member of a particular tribe would have been killed unintentionally by a member of a different tribe, the heirs of the deceased would have to be paid by the paternal relatives of the accused with an amount of blood-money (*Diyah*) as a pecuniary remedy. Those paternal relatives used to be known as *al-'Aqilah*.(4)

The central idea of the doctrine of *al-'Aqilah* is that, the members of the accused's tribe used to be mutually agreed to a financial contribution for the purpose of protecting him (the accused) from financial liability arising out of causing a culpable homicide. This form of contribution has the resemblance with the contribution paid in today's *Takaful* practices. Meanwhile the compensation paid under the doctrine of *al-'Aqilah* has also the resemblance with today's *Takaful* indemnity (benefits) paid to the victim or his heirs. The idea of *Takaful* therefore, developed through the contractual understanding and today no exception, as the scheme of *Takaful* is practiced based on the contractual relation. The rights and obligations arose herein are resulting from the contractual undertaking.

Although it is generally known to everybody that, today's *Takaful* practice is basically based on the contract of profit and loss sharing (*aqd al-Mudharabah*) and unilateral contract of donation (*aqd al-Tabarru'*), but in fact, a further closer look may

reveal some other categories of *Sharia*'h justified nominate contracts (*uqud*) which possibly directly or indirectly facilitate *Takaful* operations in the contemporary world of advanced technology (5).

Shari'ah Basis and Concept of Takaful

The *Shari'ah* basis of *takaful* can be deduced from some *general* indications in the *Qur'an*, *Sunnah* and Islamic legal maxim. *Surah al-Maidah*, verse 2, reads to the effect:

"Help (ta'awun) ye one another in righteousness (birr) and piety, but help ye not one another in sin and rancour; fear Allah, for Allah is strict in punishment". (al-Qur'an. 5:2.

In the context of the Quranic verse above, *takaful* can be considered as a form of mutual help (*ta'awun*) in furthering good and virtue i.e., by helping the participants who are in need or in hardship due to the peril or hazard that befalls them.

In the following *hadith*, the Prophet (s.a.w.) also urges people to help overcome the hardship of others:

"Whosoever removes a worldly hardship from a believer, Allah will remove from him one of the hardships of the hereafter. Whosoever alleviates the needy person, Allah will alleviate for him in this world and the next"

(Translation of Sahih Muslim, Book 32, No. 6250)

In addition to the Quranic verse and *hadith* above, there is also another *hadith* of the Prophet (s.a.w.) which implies a recommendation for people to undertake certain precautions or strategies to mitigate or reduce risk.

The Prophet (s.a.w.) noticed a Bedouin leaving a camel and he asked the Bedouin, "Why don't you tie down your camel?" The Bedouin answered, "I put my trust in Allah." The Prophet said, "Tie your camel first, then put your trust in Allah."

(Narrated by Al- Tirmizi and Ibn Majah, Book 60, No. 2517)

This *hadith* clearly indicates that a person should always take appropriate measures to safeguard himself or his property against risk of loss. Applying the lessons from the saying of the Prophet above to the practice of *takaful*, it can be said that *takaful* is a strategy of risk mitigation by way of a collective risk taking that distributes risks and harm to large numbers of participants. This mitigates the otherwise very damaging harm that can be caused to a person if the risk is to be borne individually (6). Finally, there is also an Islamic legal maxim (*qa'idah fiqhiyyah*) that is relevant to *takaful*, which reads: "*al-darar yuzal*"; meaning: "damage or harm is removed". The maxim entails that once any damage is caused or occurred, efforts must be made to remove it. In this sense, *takaful* can be considered as an effort to remove damage or harm as and when it occurs, through the payment of compensation or coverage to the victim or his family. Based on the *Quranic* verse, *ahadith* and Islamic legal maxim above, it is understood that the concept of *takaful* is generally encouraged in the *Shari'ah* "*ah*

The concept of *takaful* embraces the element of mutual protection and shared responsibility. This system entails a situation where a group of people co-operate amongst themselves to establish common resources for the purpose of mutual indemnity. Thus in essence, *takaful* is built on the concepts of mutual indemnity, solidarity and mutual help among participants who have agreed to share defined losses to be paid out of a common fund (3).

In *Takaful*, there are usually four parties involved namely: participant, operator, insured, and beneficiary. The nature of *Takaful* is that, anybody in the society who has the legal capacity may contribute a sum of money to mutual co-operative fund in view of ensuring material security for one against a defined-risk probably encountered by another's life or property. Thus, those who contribute to the mutual fund are known as participants while those who among the participants face the risk and are assisted by the fund are known as insured. Those who actually benefit from the fund are known as the beneficiaries to the cooperative fund.

The monetary contribution made by the participants to the fund is known as mutual contribution (5). The fund, managed by a registered or licensed body or corporation is known as a *Takaful* operator, who finds himself bilaterally to manage the fund according to *shari'ah* principles and also to provide a reasonable financial security for those who genuinely deserve it against the loss or damage suffered by them resulting from a defined-risk. Furthermore, the contribution made by the participants is put into two funds; one of them is investment fund according to the principles of *al-Mudharabah* (profit and loss sharing) while the other is treated as charity according to the principles of *al-Tabarru*. Both funds are termed in Malaysia as Participant's Account (PA) and Participants' Special Account (PSA) respectively.

To a further illustration on the central idea of *Takaful*, in which much emphasis is vested on the issues of 'joint benefit', 'shared responsibility' and 'shared guarantee'. Relatively, the distinct character of this form of mutual scheme is that, the contract is based on the Divine Virtues of co-operation, mutual help, shared responsibility and benefit, brotherhood and solidarity, while all aspects of the contract (*'Aqd*) should be transparent to all parties involved herein (6). The basic motive for *Takaful* under the contemporary Islamic Economy is to bring equity (*'Adl*) to all parties involved and the profit earning should not be the prime objective, rather helping other policy holders who encounter catastrophe, sharing the misfortune while sharing the profits, if any, is the actual goal. The management of *Takaful* funds, therefore, are to exercise prudence when making investment decisions and must not subject such funds to higher return with high risk phenomena (7).

To grasp the nature of *Takaful* industry, one should consider the element of *al-Tabarru'* in accordance with the principle of the joint guarantee to help others. In which each certificate holder willingly agrees to give a portion of his paid contribution in favour of other policy holders who are struck by a mishap and may in need of financial aids. This includes taking on the responsibility for safeguarding a deceased's (participant) dependents from unexpected but defined risk. The beneficiaries, in turn, must abide by the true spirit of *tabarru'* and should realize that, the amount paid to them has, necessarily, come from fellow participants. As such they should try not to indulge in any material gain, self-profiting activities with potentially may be detrimental to the benefit of other participants.

Takaful and Insurance Operational Models

The underlying contract of commercial insurance is sale and purchase of policy or protection cover, in return for payment of premium. In the arrangement, the insurer provides protection to the insured in the event of perils and disasters, or the like; in return of which, the insured pays a premium. Since the arrangement is based on sale contract where the premiums paid by the policy holders form the price or consideration for the protection promised in the policy, all of these premiums and any profit or surplus arising there from belong to the company, and are not returned or shared with the policyholders.

In contrast, the basis of payment of contribution by the participants in a *takaful* operational model is donation or *tabarru'* for the purpose of mutual indemnity among all the participants in the plan. The *takaful* operator is just an agent or manager who has been authorized to operate and manage the *takaful* fund on behalf of the participants via a *wakalah* contract or *mudarabah* contract, etc (8). Therefore, the *takaful* fund and any profit or surplus arising therefrom does not, in principle, belong to the *takaful* operator; they belong to the *takaful* participants collectively. The *takaful* operator cannot take any portion of the contribution monies in the fund, except with consent and authorization by the *takaful* participants. This factor marks a fundamental difference between commercial insurance operational model and *takaful* operational model.

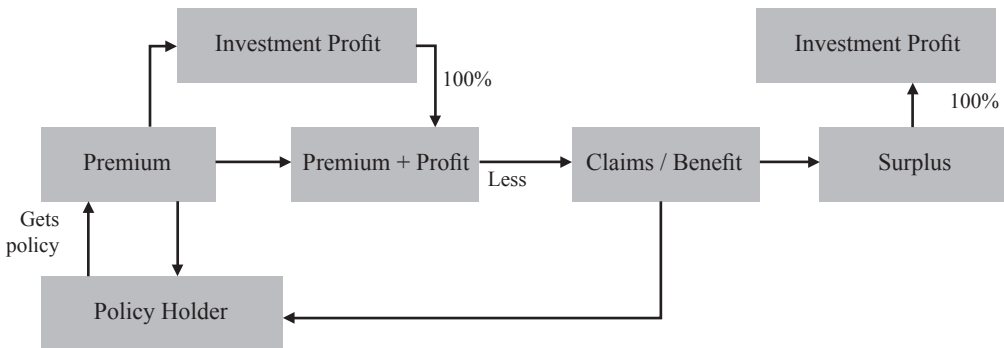


Figure 1 Commercial Insurance Operational model
Source: Engku Rabiah A.E A and Hassan Scott P.O (2008).

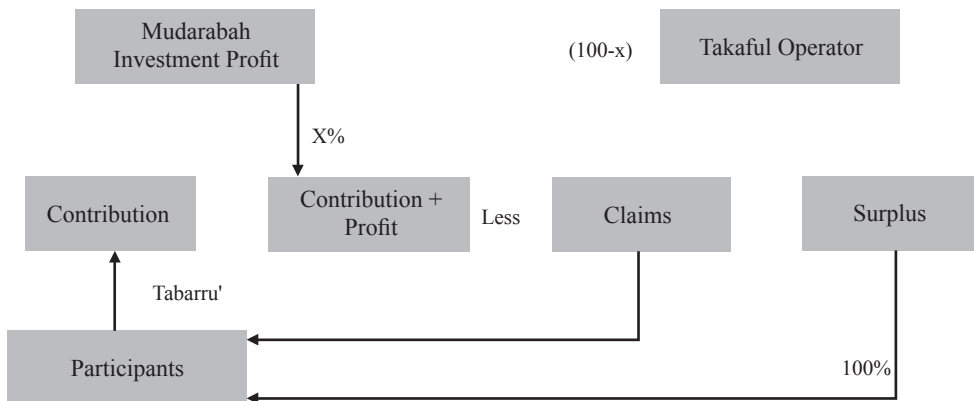


Figure 2 Basic Mudarabah Operational Model
Source: Engku Rabiah A.E A and Hassan Scott P.O (2008).

Conflicts between Conventional Insurance and the Principles of Shari'ah

Islam does not object to trade nor does it simply prohibit contracts just for the sake of it. What it seeks to ensure is justice and fair play in all dealings to all parties. Only those elements which could lead to exploitation of people or those deemed unjust by *Shari'ah* standards would be forbidden. What is basically useful to society would not be against the *Shari'ah*. The objection is not against the concept of insurance but against the existence of the weaknesses in the insurance contract namely; *Gharar* (uncertainty), *Maisir* (gambling), *Riba* (usury).

Commercial Insurance and all its contracts are relatively new developments. The pioneer Muslims neither knew it nor was it ever considered by the earlier Islamic Jurisprudents. It was for the first time examined by a Hanafi Jurist Syed Ibn Abidin at the request of some

Muslim Merchants who sought his opinion about the validity of Marine Insurance under Islamic laws (3). He discussed the essence of Marine insurance and concluded "I see that it is not permitted to any merchant to get indemnity for his damaged property against the payment of a certain sum of money known as insurance premium; because this is a commitment for what should not be committed to". The attitude towards illegality of insurance from Islamic point of view continued for full century after Ibn Abidin. However in view of the tremendous importance assumed by Insurance for the modern finance, trade and industry the Contract of Insurance has been subject matter of extensive and in depth studies and discussions amongst the Islamic Jurisprudents during the past several decades.

In 1396 H (1976) the First International Conference on Islamic Economics was held in Makkah, which was attended by more than 200 Islamic Jurists and Economists. They reached at the following decision on it:

"The Conference sees that the commercial insurance which is practiced by the commercial insurance companies in this era does not conform to the *Shari'ah* principle of cooperation and solidarity because it does not fulfil the *Shari'ah* conditions which would make it valid and acceptable".

This Conference also suggested that a committee comprising of *Shari'ah* Experts & Muslim Economists should be constituted in order to suggest a system of insurance that will be free of "*Riba*", "*Usury*" and "*Gharar*". The matter continued to receive the attention of numerous groups of Islamic Jurisprudents in cooperation with eminent and distinguished economists and insurance experts who came up with different conclusions, views and opinions. Some of them approved all forms of insurance subject to certain conditions, limitations and qualifications; others totally disapproved all of them. However an overwhelming majority of the Islamic Jurisprudents is now of the opinion that the modern western oriented insurance contract does not in its present form conform to the Islamic *Shari'ah* because of the existence of the weaknesses mentioned earlier (4).

In the first session, which was held at Makkah on Shaban 10, 1398 A.H. in the office of the Majlis-I-Fiqhi Islamia (the Assembly of Islamic Jurisprudence) deliberations were made on insurance and its different branches and kinds. Also kept in view was resolution #55 of Saudi

Arabia's Majlis-e-Hayat-i-Kibar-ul-Ulama (The Constituent Assembly of Most Eminent Religious Scholars) passed in its 10th Session at Riyadh held on 4-4-1397 A.H. declaring all kinds of commercial insurance as unlawful in Islam.

In the report, the council expressed the opinion that the main laws relating to insurance and the preponderant bulk of insurance business is in conflict with the injunctions of Islam, because:

1. There is 'gharar' in these contracts;

The existence of *gharar* may deny the contracting parties an equal bargaining power, resulting in the inability to make informed decisions as they do not adequately understand the attributes or consequences of the contract. This is reason why *gharar* is prohibited under Islamic law. The prohibition of *gharar* can be deduced from verse 29 of *surah an Nisa* which says:

“O ye who believe! Eat not of your property among yourselves in vanities, but let there be amongst you traffic and trade by mutual good-will, nor kill (or destroy) yourselves for verily Allah hath been to you Most Merciful”

(al-Qur'an, 4:29)

2. The element of *Maysir* (gambling) is present in its extreme form;

Gambling is a zero-sum game i.e. a game of chance. It involves the taking of risk that is created in the contract itself (contractual risk as opposed to trade or commercial risk). Normally gambling is also associated with the presence of *gharar*. Generally the element of *maysir* in conventional insurance is attributed to the act of purchasing the policy with the hope of getting more in terms of compensation/ indemnity if any of the perils were to occur. This is a game of chance and is prohibited in Islamic law because of the uncertainty involved.

The prohibition of *maysir* or gambling can be seen in *surah al Maidah* verse 90:

“O you who believe! Intoxicants and gambling (dedication of) stones and (divination by) arrows are an abomination, of satan's handwork: eschew such (abomination). That ye may prosper”.

(al-Qur'an 5:90)

3. There is an element of *riba* (usury) in these contracts;

The conventional insurance is also said to be tainted with the elements of *riba*. The occurrence is usually through the investment of the premium payments in *riba*-based financial instruments such as interest bearing accounts. The prohibition of *riba* is made in various chapters of the *Holy Qur'an* one of which is seen in *Surah al-Baqarah*, 275-281.

“Those who devour usury will not stand except as stand one whom the evil one by his touch hath driven to madness. That is because they say: trade is like usury,” but Allah permitted trade and forbidden usury. Those who after receiving direction from the Lord, desist shall be pardoned for the past, their case is for Allah to judge, but those who repeat (the offence) are companions of the fire, they will abide therein (forever).

All will deprive usury of all blessing, but will give increase for deeds of charity, for He loveth not creatures ungrateful and wicked”.

(al-Quran 2: 275-276)

4. Such arrangements come within the definition of ‘*akle-mal-batil*’ i.e. unlawful Acquisition.

Similarly, the Council of Islamic Ideology of Pakistan gave a decision in December, 1983 that the well-known and current forms of insurance are in conflict with the Islamic injunctions.

“The contract of insurance, in all its forms, is unlawful, corrupt, false, prohibited and not promulgatable.”

The report to the “*Badan Petugas Khas- Malaysia*” elaborated on the issue of *gharar* by describing the principles of contract according to Shari’ah as follows: “The essential elements (*rukun*) of contract are 3, namely.

- “*Aqid*” i.e. the parties to the contract
- “*Ma’kud ‘Alaih*” i.e. the subject-matter of the contract (exchange of property, service or payment)
- “*Sighah*” offer and acceptance

One of the most essential elements with regard to the insurance contract is the *rukun* of “*Ma’kud ‘Alaih*”. In insurance the exchange of the “*Ma’kud ‘Alaih*” happens when the insured pays the premium in exchange for a promise of compensation arising from a specified event insured against. In view of this, the Scholars view insurance contracts as those for the exchange of goods or services.”

Report to the “Badan Petugas Khas”, pg. 18 para 2.6. (translation)

Similarly, Dr.Yusuf al-Qaradawi, does not think that the concept of insurance conflicts with the teaching of Islam. However, he does find certain practices of conventional insurance in need of modification to bring it in line with Islamic teachings:

“Our observation that the modern form of insurance companies and their current practices are objectionable Islamically does not mean that Islam is against the concept of insurance itself; not in the least – it only opposes the means and methods. If other insurance practices are employed which do not conflict with Islamic forms of business transactions, Islam will welcome them”.

The Lawful and the Prohibited in Islam (English translation) pg.276

Difference between Takaful and Insurance

Fundamentally the difference lies in the fact that in the *Takaful* concept, the premium is paid on the basis of *tabarru’*. This changes the contract because with *tabarru’*, it is the

participants themselves who are carrying the risk and not the insurance company. The Takaful operator is clearly not the owner of the fund but truly its custodian. As such, the Takaful operator cannot use the contributions except as intended by the donors i.e. for mutual help. By including the concept of *tabarru'*, the element of *gharar* would be eliminated, which consequently eradicate *maysir* from the transaction. This is because with *tabarru'*, the contract is no longer that of exchange, thus eliminating the problem of deliverability. In addition, the *tabarru'* factor also inculcates the spirit of solidarity, brotherhood and mutual help (9).

The distinction between the conventional insurance and *Takaful* business is more visible with respect to investment of funds. While insurance companies invest their funds in interest-based avenues and without any regard for the concept of *Halal-o-Haram*, Takaful companies undertake only *Shari'ah* compliant business (invest their funds in financial instruments, which are not forbidden by Islam) and the profits are distributed in accordance with the pre-agreed ratios in the Takaful Agreements. Likewise they share in any surplus or loss from the pool collectively. Takaful system has a built-in mechanism to counter any over-pricing policies of the insurance companies because whatever may be the premium charged, the surplus would normally go back to the participants in proportion to their contributions. (10)

General Takaful companies maintain two separate and distinct accounts - one known as the Participants Fund and the other Shareholders Fund. Takaful companies must have *Shari'ah* Supervisory Council to monitor their operation to make sure they do not engage in forbidden practices such *riba*.

Table 1 Comparison between Insurance and Takaful

	Takaful	Insurance
Contract	A combination of <i>Tabarru'</i> contract (donation) and agency or profit sharing contract.	An exchange (sale and purchase) between insurer and insured.
Responsibility of policy holder/participants	- Participants make contributions to the scheme - Participants mutually guarantee each other under the scheme	Policy holders pay premium to the insurer
Liability of the insurer/operator	Takaful operator acts as the administrator of the scheme and pays the takaful benefits from the takaful funds.	Insurer is liable to pay the insurance benefits as promised from the assets shareholders
Access to capital	Access to share capital by takaful operator but not to debt, except for interest-free loan to rectify the deficiency.	Access to share capital and debt with possible use of subordinated debt
Investment of funds	Asset to the takaful funds are invested in <i>Shari'ah</i> compliant instrument.	There is no restriction apart from those imposed for prudential reasons.

Conclusion

Different views have been expressed about the conventional insurance from the point of view of Islam. An overwhelming majority of the *Shari'ah* scholars believe that it is unlawful. The religious scholars have objection to the concept of conventional insurance. In their view the elements of *Gharar* (Uncertainty), *Maysir* (Gambling) and *Riba* (Usury) are involved in insurance contracts, which make it un-Islamic. Takaful thus provides us with an alternative to insurance in order to plan for eventualities and uncertainty of life and provides a unique opportunity to galvanize the savings of the individual for the good of the *Ummah*, institute financial discipline and encourage individuals to adopt suitable financial planning habits. It will provide security to the individual, the family, the society and the country. Let us make a determined effort to eliminate the 'debt trap' and move forward using our own resources and imagination.

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