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# Takaful (Islamic Insurance): When We Started and Where We are Now

Syed Ahmed Salman<sup>1,\*</sup>, Hafiz Majdi Ab. Rashid<sup>2</sup>, Sheila Nu Nu Htay<sup>3</sup>

<sup>1</sup>Institute of Islamic Banking and Finance, International Islamic university Malaysia, Kuala Lumpur, Malaysia

<sup>2</sup>Kulliyah of Economics and Management Sciences in International Islamic University Malaysia, Kuala Lumpur, Malaysia

<sup>3</sup>International Council of Islamic Finance Educators Malaysia, Mandalay, Myanmar

## Email address:

salmaniium@gmail.com (S. A. Salman), hafizmajdi@gmail.com (H. M. Ab. Rashid), sheilahtay14@gmail.com (S. N. N. Htay)

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**Abstract:** The idea and practice of Takaful is not new as it was practiced during the time of the Prophet Muhammad (PBUH) by its adoption of the concept of *Aqilah*. Due to the complex nature of business activities and evolving human needs, Takaful is now fully commercialised and is an important part of the financial markets. Since it is important in our daily life, we believe that it is necessary to highlight when and how Takaful started and how it has developed. By doing so, we will know that the practice of Takaful is inherited from the Prophet (PBUH) and we will better appreciate the contributions of Muslim scholars to revitalize this industry. The discussion of this paper focuses on the historical development of Takaful, its available products, models, and regulatory framework. The practice of insurance was officially prohibited in 1976. Since then, Takaful has been introduced as *Shari'ah* compliant insurance product. Currently, there are 174 Takaful operators in the key Takaful markets and a variety of Takaful products are available to cater the market need. To achieve the sustainable development of the Takaful industry in the conventional world, *Shari'ah* scholars have developed several Takaful models. In addition, international organisations such as the Islamic Financial Services Board and the Accounting and Auditing Organisation for Islamic Financial Institutions are supporting the industry by providing guidelines. This paper acknowledges that the Takaful industry is one of the fastest growing financial industries and current loopholes can be improved upon jointly by the industrial players, Shari'ah advisors and internal organisations.

**Keywords:** Insurance, Takaful, Products, Models

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## 1. Introduction

In the context of insurance or Takaful, risk can be described as the probability of undesirable outcome due to the unforeseen future [1, 2, 3-4] Since risk can bring unwanted and negative consequences, it should be managed. One of the ways is to have an insurance or Takaful product. Risk management is allowed in both conventional and Islamic viewpoints [5]. The concept of insurance is excellent and it can provide financial assistance when misfortune inflicts the policyholders according to the terms and conditions of the insurance contract. When the insurance companies receive the premium from the policyholders, they have to find ways to generate income to pay the claims and to pay dividends to the shareholders. Hence, they normally invest in securities which are not *Shari'ah* compliant from

which they might earn interest. In the insurance game, the policyholders will win if they make claims but if not, they will lose the premium. At the same time, the insurance companies will gain if the policyholders do not make any claim but if they claim, the insurance companies are the losers. This practice involves gambling because the gain of one party is the loss of another. The end result is that it will bring injustice to the society. Gambling in insurance is a form of uncertainty. The future is uncertain and policyholders are unsure which particular unfortunate event will hit them when they must pay the insurance premium [6, 7-8]. Thus, conventional insurance is prohibited in Islam due to the involvement of prohibited elements such as interest, uncertainty, and gambling.

The concept of Takaful is based on the mutual corporation and assistance among participants. It is intended for all regardless of religion [9]. It seems that it is widely accepted

and offered even in non-Muslim countries. Many researchers have written on Takaful.

However, to the extent of our knowledge, there is limited research on the comprehensive development of Takaful and its current products and models. Therefore, this paper addresses this issue through a documentary approach. This paper is presented in six sections. The second section explains the historical development of Takaful. The third section discusses currently available Takaful products. The fourth section demonstrates how the Takaful models work. The fifth section discusses the regulatory framework of Takaful. The last section provides a conclusion, discussion, and suggestion for the Takaful industry to advance.

## 2. Historical Development of Takaful (Islamic Insurance)

The original concept of the Takaful practice can be traced back during the time of the Prophet (PBUH). He approved this practice whereby the family of the killer contributes money to the immediate family of the dead. Its purpose is to help the family members who depend on the person who was unlawfully killed [10]. The practice of *Aqilah* was continued by the companions of the Prophet (PBUH). For instance, Sayyidana ‘Umar (r) commanded that a *Diwan of Mujahidin* provide mutual help among themselves if anyone of them commits murder [11, 12].

During the 14<sup>th</sup> to 17<sup>th</sup> century, insurance practices focused on maritime trade. During the 19<sup>th</sup> Century, a Hanafi lawyer Ibn Abidin (1784 –1836) became the primeval Islamic philosopher to develop the importance, general notation or idea and legal basis of an insurance agreement [13]. He is the first person who discussed the legal basis of insurance and starting from that time, insurance practices were based on legal institutions, not based on customary practice. In addition, Islamic jurists started issuing fatāwas on the illegitimate nature of conventional insurance and introduced Takaful as an alternative to insurance in the 20<sup>th</sup> century [14, 15-16]. According to these scholars, Takaful should be based on the contract of donation (*uqud tabarruat*), instead of the conventional commercial contract of exchange (*uqud muawadhah*) as the latter contains major elements of *Riba*, *Maysir* and *Gharar* which invalidate the conventional insurance contract.

Such institutions include [17]:

- The Higher Council of Saudi Arabia in 1397 AH (1976 CE)
- The Fiqh Council of Muslim World League in 1398 AH
- The Fiqh Council of the Organization of the Islamic Conference in 1405 AH
- The Grand Counsel of Islamic Scholars in Mecca, Majma AL-Fiqh in 1985

EY Global Takaful Insights [18] provides the key milestones in the current development of the global Takaful industry. In 2002, Lebanon (in the region of MENA) entered the Takaful market by establishing Al Aman Takaful. In Asia,

the Islamic Financial Services Board (IFSB) was established. In 2003, Pakistan (in the Asian region) established Pak Kuwait Takaful Limited and this is the first Takaful Company in the country. In the case of regulatory development, in 2005, Saudi Arabia enacted Saudi Arabia Monetary Authority (SAMA) regulations for cooperative insurance supervision and Bahrain enacted Bahrain Monetary Authority Rules, which includes rules related to Takaful. In addition, the Securities and Exchange Commission Pakistan (SECP) issued Takaful rules in Pakistan. In Europe, the significant milestones started in 2006. Hannover Re from Germany and Swiss Re from Switzerland entered the ReTakaful industry. In 2007, Munich Re from Germany joined the ReTakaful industry. In 2008, the Salaam Insurance Company was established in Britain. In 2011, Kenya entered the Takaful market with Takaful Insurance Africa and Saudi Arabia directed all the operators to use the cooperative insurance model. In 2012, Islamic Finance Amendment Rules 2012 allowed the operation of Takaful by conventional firms. Similarly, Pakistan allowed a Takaful window, while Malaysia launched its Takaful operating framework. In 2013, Cobalt from Britain launched the platform for writing large commercial risks (*Shari'ah* compliant) in the London market. Dubai tried to become the capital of global Islamic economy. Indonesia proposed a new Act to phase out Takaful windows and Islamic Financial Services Act (IFSA) requiring the separation of family and general Takaful into separate entities.

EY Global Takaful Insights [18] further highlights the number of Takaful operators in key Takaful market centres. According to this report, the total number of Takaful operators in the key market is 174 comprising of 34 in Saudi Arabia, 11 in Malaysia, 43 in GCC countries (excluding Saudi Arabia), 29 in ASEAN (excluding Malaysia), 12 in South Asia, 36 in Africa and 9 in the Levant. Family and medical Takaful are the major business lines in the markets, for instance, 80% in South Asia, 50% in ASEAN and 47% in MENA belong to family and medical Takaful. In addition, the report forecasts the future of Takaful contribution for the 2014 and 2015 in five main key markets such as Saudi Arabia, ASEAN, GCC, Africa, South Asia, and the Levant that have high potential growth trends.

## 3. Takaful Products

There are two main categories of Takaful products, i.e. general Takaful and family Takaful [19, 20-21, 16].

### 3.1. General Takaful

According to IFSB [22], general Takaful is defined as, “schemes which are basically contracts of joint guarantee on a short-term basis (normally one year), and providing mutual compensation in the event of a specified type of loss”. The schemes are designed to meet the needs for the protection of individuals and corporate bodies in relation to material loss or damage resulting from a catastrophe or disaster inflicted upon real estate, assets or belongings of participants. The Takaful contribution paid is pooled into the Participant Risk

Fund under the principle of *Tabarru* to match the risk elements of the business that are inherent in its underwriting activities.”

According to [23], the participants can engage with Takaful for the assets which are recognised as valuable items according to the *Shari'ah*. For instance, a factory producing alcohol is not allowed to apply for general Takaful. In addition, the potential loss incurred must be accidental and unintentional. This is seen in Surah al-Baqarah, 195:

“*And spend of your substance in the cause of Allah, and make not your own hands contribute to (your) destruction; but do good, for Allah love those who do good*”

The main types of general Takaful products are motor vehicle Takaful, fire Takaful, marine Takaful and engineering Takaful. Takaful for motor vehicles, motorcycles and commercial vehicles are under motor vehicle Takaful. In the case of fire Takaful, it covers Takaful for standard fire, house owner or householder and home package. Marine cargo and marine hull or machinery are the sub products of marine Takaful and machinery break-down and construction risk are under engineering Takaful [23, 14].

### 3.2. Family Takaful

Family Takaful provides protection and long-term saving and investment opportunities. By having family Takaful products, it will release the financial burden on the family in times of misfortune and return will be accumulated from the investment account managed by the Takaful operators. There are two main types of family Takaful products, namely individual family Takaful products and group family Takaful products.

Individual family products comprise of protection product, investment product, retirement product and medical product.

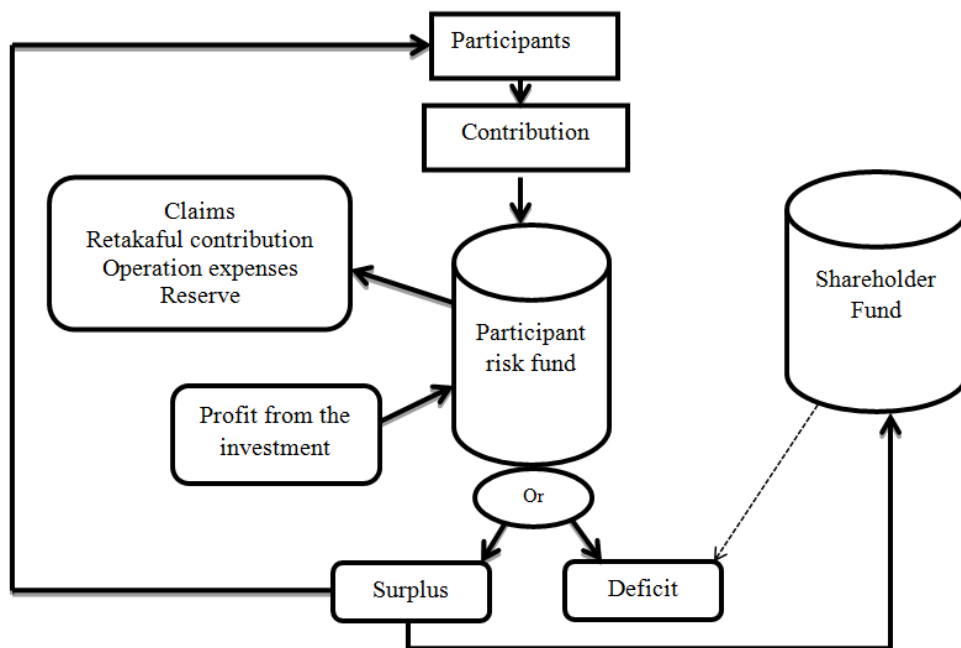
Family Takaful protection aims to provide the financial help for the beneficiaries of participant when the participant dies or becomes permanent disabled. In addition, this product also tries to release the financial burden from the participant if he suffers critical illness or temporary (totally or partially) disability. In the case of family Takaful investment products or investment-linked family Takaful products, it provides investment opportunities in addition to the protection given to the participants. Retirement family Takaful products provide financial assistance to the participant when he retires from work. The Takaful benefit of this product is that the participant is entitled to get the adequate financial support after retirement and to cover the medical expenses in old age. Medical family Takaful products cover the cost of hospitalisation and surgery [23, 14].

Group family Takaful is normally subscribed to by the employers for the benefit of employees and their family members. Similar to the individual family Takaful products, it provides financial assistance to the participants in order to cover hospitalization, surgery, and normal medical expenses. The coverage amount depends on the contribution given by the employer or employees [23].

## 4. Takaful Models

Seven Takaful models are discussed. These models are Cooperative (*Taa'wuni*) Model, Pure *Wakalah* (Agency) Model, Modified *Wakalah* Model, Pure *Mudarabah*, Modified *Mudarabah* Model, Hybrid *Wakalah-Mudarabah* Model and *Waqf* Model. In addition, the brief comparison of these model is explained.

### 4.1. Cooperative (*Taa'wuni*) Model



Source: Adopted from [24, 25].

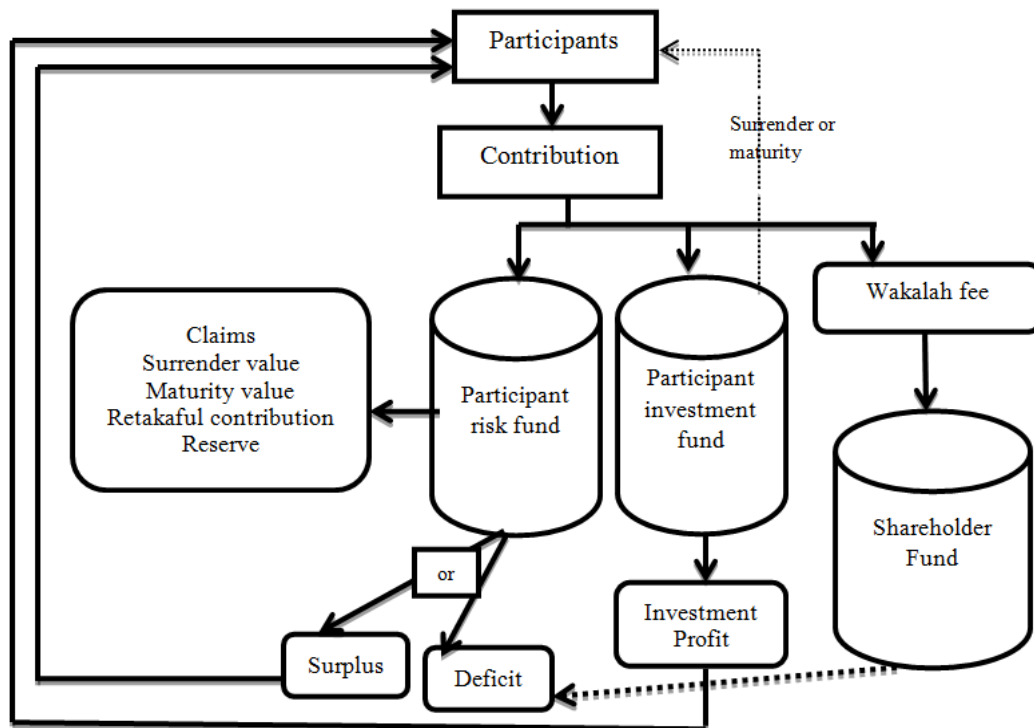
Diagram 4.1. Cooperative (*Taa'wuni*) Model.

In this model, when the participants contribute, all will be accumulated in the participant risk fund (PRF), from which the claims, Re-Takaful contribution, and operating expenses will be paid. In addition, some portion of PRF will be invested to generate income. Any surplus in the PRF (Participants' contribution + Income from the investment – Claims – ReTakaful expenses – Reserve – Operating expenses) will be shared between shareholders and participants. For maturity, the participants will receive their respective amount from the PRF and in the case of surrender, similar to the case of maturity. In the case of deficit, the Qard loan (interest free loan) will be given from the Shareholder fund (SF) and it should be paid back to the SF [24, 25]. It is demonstrated by Diagram 1.

**4.2. Pure Wakalah (Agency) Model**

In this model, the relationship between Takaful operators (TOs) and participants is the principal-agent relationship.

TOs act as an agent on behalf of participants to make investment and manage the funds. Normally, Wakalah fee is to cover commission fees, operating expenses and management of investment. In this situation, the contribution received from the participants will be split into Wakalah fee, PRF and PIF. TOs do not share the investment profit and the surplus from PRF. For claims, it will be paid out of the PRF. In the case of maturity, the participant will be receiving his respective amount (portion from contribution which has been investment and profit from the investment) from the PIF (if any) and the maturity value from the PRF. When the participants surrender before maturity, he will get his respective amount (portion from contribution which has been investment and profit from the investment) from the PIF (if any) and surrender value from the PRF. However, in the case of deficit, the qard loan (interest free loan) will be given out from the SF and it should be paid back to the SF [24, 25]. It is demonstrated by Diagram 4.2.



Source: Adopted from [24, 25].

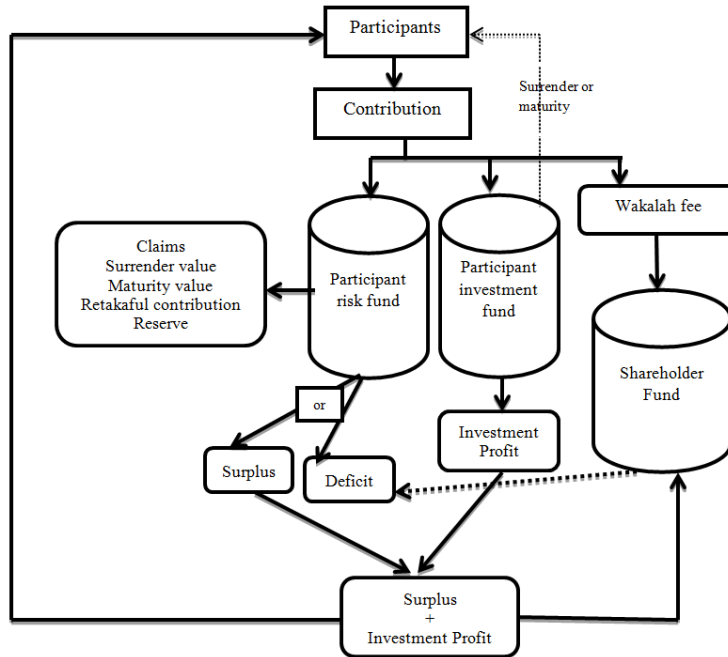
Diagram 4.2. Pure Wakalah (agency) Model.

**4.3. Modified Wakalah Model (Wakalah with Incentive Compensation)**

In this model, the relationship between TOs and participants is the principal-agent relationship; however, the TOs are allowed to share the surplus from the PRF. The purpose of this model is to give incentive to TOs for their efficient management. Similar to the Wakalah model, the Wakalah fee is to cover commission fees, operating expenses and management of investment. The contribution received from the participants will be split into Wakalah fee, PRF and

PIF. TOs share the surplus from the PRF and investment profit. For claims, it will be paid out of the PRF. In the case of maturity, the participant will be receiving his respective amount (portion from contribution which has been investment and profit from the investment) from the PIF (if any) and maturity value from PRF. When the participants surrender before maturity, he will get his respective amount (portion from contribution which has been investment and profit from the investment) from the PIF (if any) and surrender value. However, in the case of deficit, the qard loan (interest free loan) will be given out from the SF and it

should be paid back to the SF [24, 25]. It is demonstrated by Diagram 4.3.



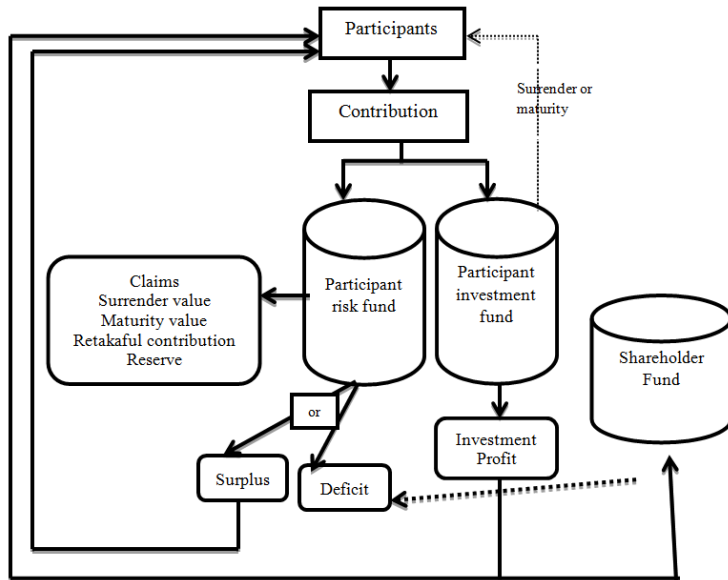
Source: Adopted from [24, 25].

Diagram 4.3. Modified Wakalah Model.

**4.4. Pure Mudarabah (Investment Profit-Sharing) Model**

In this model, the contractual relationship between the participants and TOs is based on the concept of profit sharing. Participants are the capital providers while TOs provide the services by managing the fund provided by the participants. The income of the TOs is solely based on the share of the profit from the PIF. There is no *Wakalah* fee for the TOs. For claims, it will be paid out of the PRF. In the case of maturity, the participant will receive his respective amount (portion

from contribution which has been investment and profit from the investment) from the PIF (if any) and the maturity value from the PRF. When the participants surrender before maturity, he will get his respective amount (portion from contribution which has been investment and profit from the investment) from the PIF (if any) and surrender value from PRF. However, in the case of deficit, the Qard loan (interest free loan) will be given out from the SF and it should be paid back to the SF [24, 25]. It is demonstrated by Diagram 4.4.



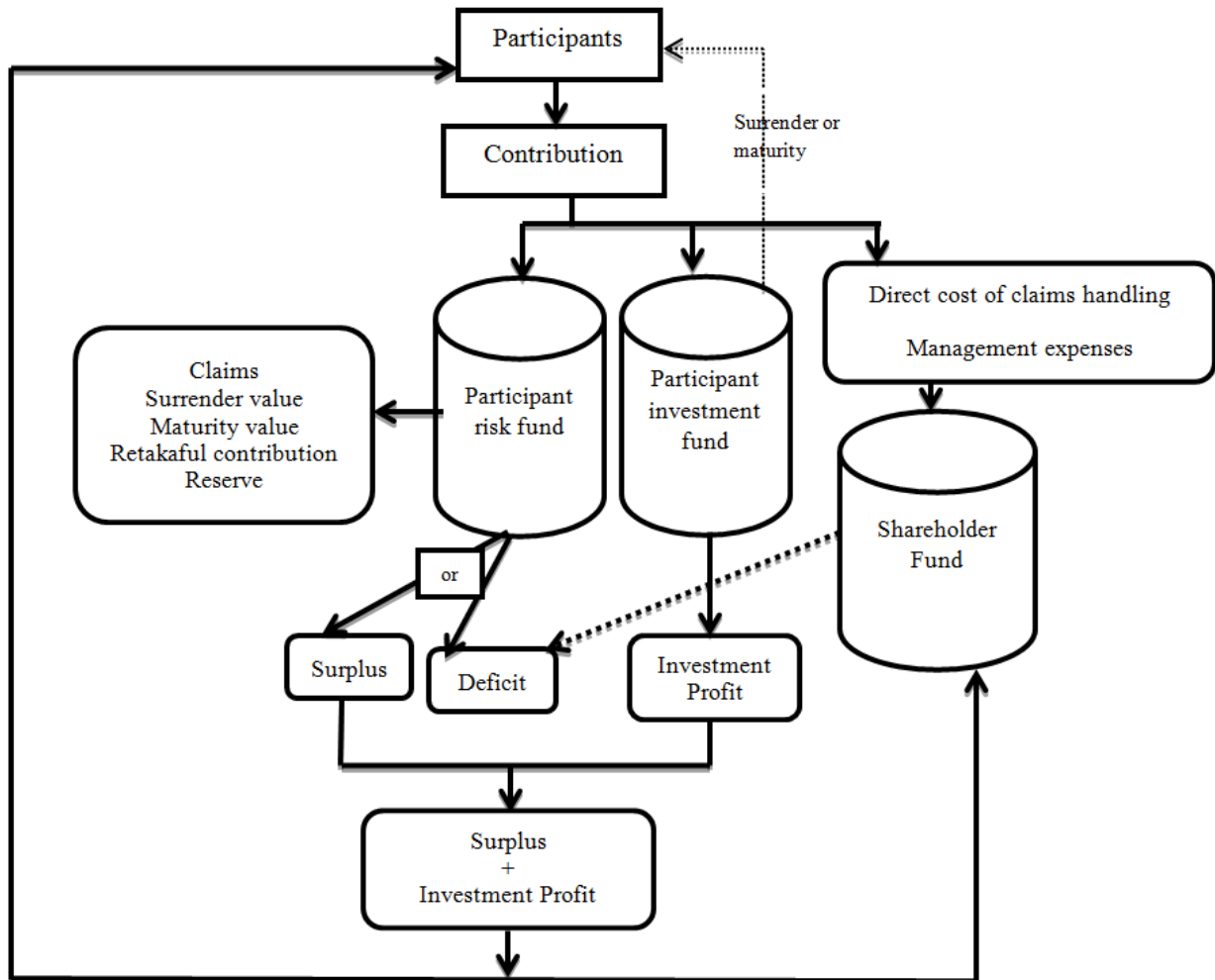
Source: Adopted from [24, 25].

Diagram 4.4. Pure Mudarabah Model.

**4.5. Modified Mudarabah Model**

This model allows the TOs to charge the direct cost of handing the claims and management fee before computing surplus or deficit. At the same time, TOs are allowed to share the surplus from the PRF and the profit from the PIF. The contribution received from the participants will be split into monitoring fee (i.e. direct cost of handing the claims and management fee), PRF and PIF. For claims, it will be paid out of the PRF. In the case of maturity, the participant will be receiving his respective amount (portion from contribution

which has been investment and profit from the investment) from the PIF (if any) and the maturity value from the PRF. When the participants surrender before maturity, he will get his respective amount (portion from contribution which has been investment and profit from the investment) from the PIF (if any) and the surrender value from. However, in the case of deficit, the *Qard* loan (interest free loan) will be given out from the SF and it should be paid back to the SF. It is demonstrated by Diagram 4.5.



Source: Adopted from [24, 25].

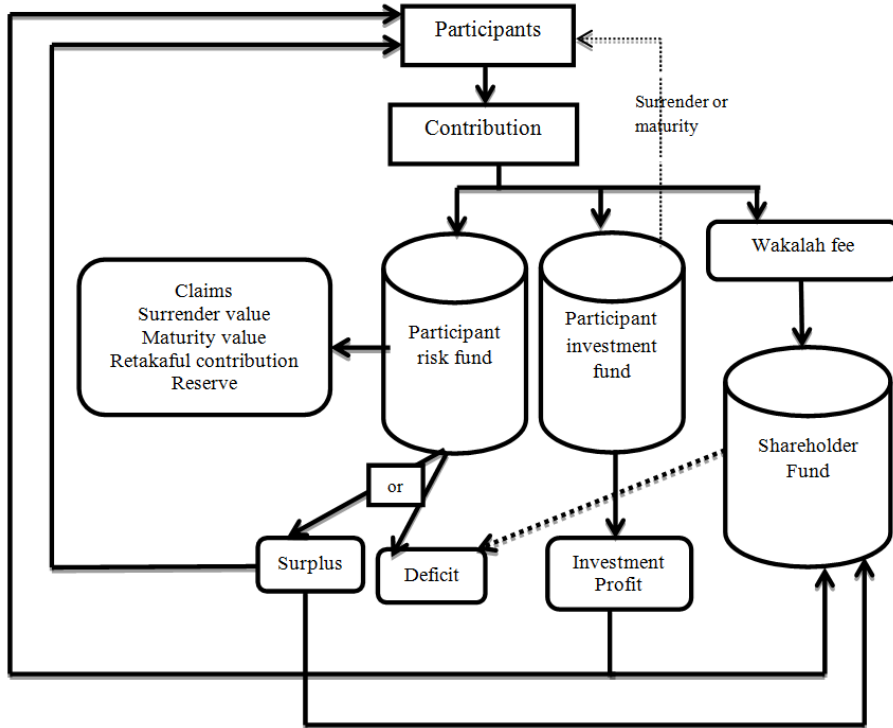
**Diagram 4.5.** Modified Mudarabah Model.

**4.6. Hybrid Wakalah-Mudarabah Model**

This model combines the principles of *Wakalah* and *Mudarabah*. For the underwriting function, the concept of *Wakalah* is used and for investment, *Mudarabah* is used. The TOs have the stable income, i.e. *Wakalah* fee, compared to the Pure *Mudarabah* model. At the same time, TOs are allowed to share the surplus from the PRF and the profit from the PIF. Operating expenses including commission are paid from the *Wakalah* fee. The contribution received from the participants will be split into *Wakalah* fee, PRF and PIF. For

claims, it will be paid out of the PRF. In the case of maturity, the participant will be receiving his respective amount (portion from contribution which has been investment and profit from the investment) from the PIF (if any) and the maturity value from the PRF. When the participants surrender before maturity, he will get his respective amount (portion from contribution which has been investment and profit from the investment) from the PIF (if any) and surrender value from the PRF. However, in the case of deficit, the *Qard* loan (interest free loan) will be given out from the SF and it

should be paid back to the SF [24, 25]. It is demonstrated by Diagram 4.6.



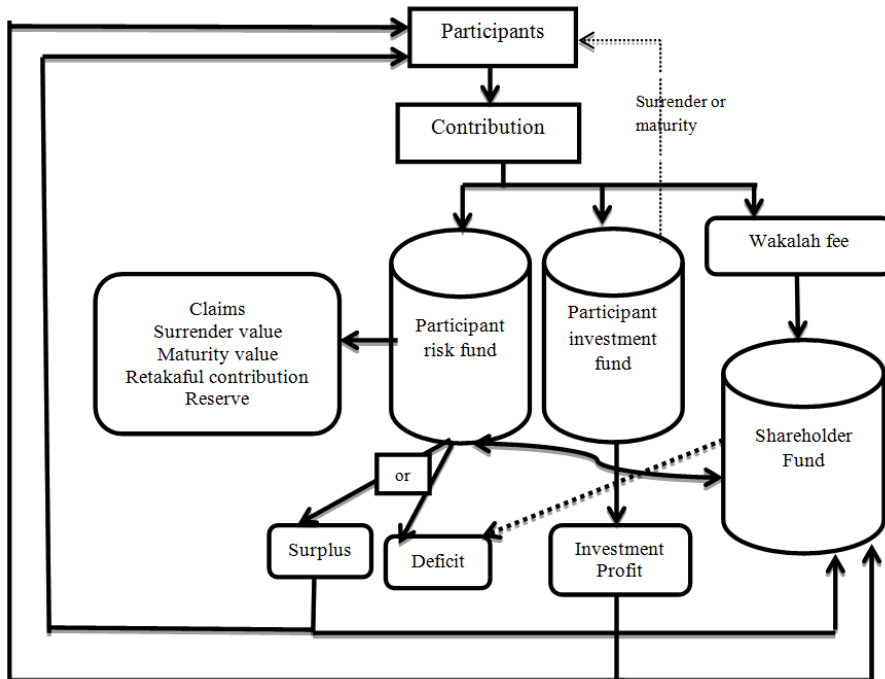
Source: Adopted from [24, 25].

Diagram 4.6. Hybrid Wakalah-Mudarabah Model.

4.7. Waqf Model

This model has additional features to the Hybrid *Wakalah-Mudarabah* model. That additional feature is that the shareholders need to put the same amount of money in the

PRF to start the waqf. Other than the initial donation as waqf, the rest will be similar to the Hybrid *Wakalah-Mudarabah* model [24, 25]. This is demonstrated by Diagram 4.7.



Source: Adopted from [24, 25].

Diagram 4.7. Waqf Model.



#### 4.8. Comparison Among Seven Takaful Models

Regarding the contribution received by the Takaful operators, it has been channeled into Wakalah fee, Participant Risk Fund (PRF) and Participant Investment Fund (PIF) except in Cooperative model, Pure Mudarabah model and Modified Mudarabah model. In the case of Takaful claims, payment for surrender, payment for maturity, Retakaful and reserve, all the models have the same practice by giving from the PRF. Surplus is shared between the Takaful operators and participants except in the Pure Wakalah and Pure Mudarabah models. In these two models, only the participants can receive the surplus distribution. Concerning the profit from the PIF, it can be shared between the Takaful operators and participants except the Cooperative and Pure Wakalah models. In the Cooperative model, there is no PIF and in the Pure Wakalah model, only the participants can get the profit. In the case of interest free loans, all the models are entitled to it. There are slight deviations among the models and hence Takaful operators are allowed to choose any model which best suits them and the participants.

### 5. Regulatory Framework of Takaful

The IFSB and AAOIFI are the international standard-setting bodies for the Islamic financial services industry. They have produced many standards related to Islamic financial institutions. Among them, the standards and documents issued by IFSB for the *Takaful* industry are Guiding Principles on Governance for *Takaful* (Islamic Insurance) Undertakings (IFSB-8:), Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services (IFSB-9), Guiding Principles on *Shari'ah* Governance Systems for Institutions offering Islamic Financial Services (IFSB-10), Standard on Solvency Requirements for *Takaful* (Islamic Insurance) Undertakings (IFSB-11), Guidance Note on the Recognition of Ratings by External Credit Assessment Institutions (ECAIS) on *Takaful* and Re-*Takaful* Undertakings (GN-5), Issues in Regulation and Supervision of *Takaful* in 2006 and Islamic Financial Services Industry Development: Ten-Year Framework and Strategies in 2007. AAOIFI has issued the AAOIFI Islamic insurance standard no. 26 in 2010. In addition, individual countries, for instance, Malaysia have come out with the *Shari'ah* Governance Framework and other regulatory guidelines specifically for the Takaful operators.

### 6. Current Takaful Market and Issues

There are 174 Takaful companies in the key market, including of 34 in Saudi Arabia, 11 in Malaysia, 43 in GCC countries (excluding Saudi Arabia), 29 in ASEAN (excluding Malaysia), 12 in South Asia, 36 in Africa and 9 in the Levant. Among the Takaful products, Family and medical Takaful are

the main products in the markets, for instance, 80% in South Asia, 50% in ASEAN and 47% in MENA belongs to family and medical Takaful. It is foreseen that the future of Takaful contribution for the 2014 and 2015 in five main key markets such as Saudi Arabia, ASEAN, GCC, Africa, South Asia and Levant that have high potential growth trends [18].

Although the Takaful market is rapidly growing, the Takaful industry needs a lot of improvement in order to maintain its competitive position in the world market. For instance, Annuar and Abu Bakar [26], point out those accounting policy choices by two Takaful operators, namely, Takaful National Sdn. Bhd. and Syariakt Takaful Malaysia Berhad in Malaysia are different. According to them, it is due to the *Shari'ah* variation between *Shāfi'ī* and *Hanīfi* and *Maliki*. It evidenced that the current Takaful market needs harmonization among the different school of thoughts. The regular training should be given to the *Shari'ah* advisors and the *Shari'ah* advisory board comprises of advisors who have knowledge in the operational aspect of the industry since they might not know the operational aspects of the Takaful operators. The findings of Htay [27] show that majority of the *Shari'ah* advisors are not exposed to the underwriting and risk rating practices of family Takaful in Malaysia and hence, it is difficult for them to decide whether the determinants used in the underwriting process are ethical and *Shari'ah* compliant. Another challenge of the Takaful industry is the awareness since Akhter and Hussain [28] find that the awareness is very low in Pakistan. In order to overcome this, Takaful operators should focus on the marketing.

### 7. Conclusion, Appreciation, and a Way Forward

This paper has presented the evolution of Takaful and its products such as general and family Takaful products and its seven models which are widely used nowadays. This paper aims to appreciate the *Shari'ah* scholars for their strong support for the survival of Takaful industry in the competitive business environment. They have contributed significantly to the industry by developing the Takaful models and by providing the *Shari'ah* compliant guidelines and by advising and monitoring the industry. In addition, the commitment of the Takaful operators should not be forgotten. Without the willingness and support from the top management of the companies, the industry cannot reach to the stage that we are achieving right now. The efforts of international Islamic organisations such as AAOIFI and IFSB in providing the guidelines for the Takaful industry are commendable. It is recommended that for the Takaful industry to advance, the support from the regulatory bodies is the main determinant and hence, it is expected that this industry will be given attention and receive support from both Muslim and non-Muslim countries.

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