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A SHARĪʿAH COMPLIANCE REVIEW ON INVESTMENT LINKED TAKĀFUL IN MALAYSIA

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The growth in Islamic funds has brought new challenges and opportunities for the financial industry. In recent years, the trend has been towards unit-linked products with an emphasis on the investment link which definitely includes the takāful *industry.* Takāful *operators are offering investment products apart from their core business in providing protection through General and Family* Takāful. *This paper aims to review some* Sharīʿah *issues in investment-linked* takāful *schemes.*

1. INTRODUCTION

Takāful is derived from an Arabic word [*kafala*] which means solidarity whereby a group of participants agree amongst themselves to support one another jointly against a defined loss. In a *takāful* arrangement, the participants contribute a sum of money as wholly or partially *tabarruʿ* (donation) into a common fund, which will be used mutually to assist the members who suffer a defined loss or damage.[1]

Takāful business can be divided into General *Takāful* and Family *Takāful*. Basically, General *Takāful* reflects absolute *tabarruʿ* where the participants do not expect any return from their contribution except claims, if any. In Family *Takāful*, the *tabarruʿ* is partial, therefore besides claims (if any) participants also expect return from their investment. This is because the participants' contribution is divided into two separate accounts: the individual personal account and the *tabarruʿ* (risk/solidarity) account. The individual account, to which the major portion of the premium is allocated, is purely for savings and investment. The *tabarruʿ* account, where the balance of the premium goes, is to build up a reserve for death benefits to the heir(s) of the participant who dies prematurely or for the

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[1] See Issues in Regulation and Supervision of Takaful, Islamic Financial Services Board (IFSB) and International Association of Insurance Supervisors (IAIS), August 2006

participant's own benefit in case of total permanent disability. The participant, therefore, applies the concept of *tabarru*ʿ in the *tabarru*ʿ account. The *Takāful* operators invest those funds of the personal and *tabarru*ʿ accounts in *Sharīʿah*-compliant investment instruments. *Takāful* operators normally give the participant the right to know how the fund is managed, how surrender values are computed and how profits are shared.[2]

2. TAKAFUL MODELS

Before we look at *Sharīʿah* issues on investment-linked products, it is important to look at the existing *takāful* models which are the backbones for the *takāful* business operation. There are several forms of contract that govern the relationship between the participants (policyholders) and the *takāful* operator. The most widely used contracts are: *tabarru*ʿ, *wakālah* (agency) and *muḍārabah* (profit-sharing).

The Sharīʿah Advisory Council of Bank Negara Malaysia[3] has made the resolution that a *takāful* contract is generally established on the *Sharīʿah* principles of *tabarru*ʿ and *taʿāwun* (mutual cooperation), apart from the agreement among the contracting parties. In the formulation of a *takāful* product, the principle of *tabarru*ʿ has been the main underlying *Sharīʿah* principle, although the application of other principles such as *wakālah* and *muḍārabah* also complement the *takāful* operational structure.

3. WAKĀLAH MODEL

Wakālah is a process of assigning or entrusting to another person a certain task. This task, by virtue of the law, is permitted to be assigned to another person. Under this model, the principal agent relationship is used for both underwriting and investment activities. In underwriting, the *takāful* operator acts as an agent on behalf of the participants to run the *takāful* fund. All risks are borne by the fund and any operating surplus belongs exclusively to the participants. The *takāful* operator does not share directly in either the risk borne by the fund or any surplus/deficit of the fund. Instead, the operator receives a set fee called a *wakālah* fee for managing the operation on behalf of the participants, which is usually based

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[2]Bank Negara Malaysia Concept Paper "Guidelines on Takaful Operational Framework" 2009. See clause 10.10, " Sound investment management in *takāful* operations is important to achieve not only appropriate returns to meet different objectives of the *takāful* funds but also to ensure that the funds can meet the obligations when *takāful* benefits fall due, including on surrender and maturity of *takāful* certificates. It is the *takāful* operators' fiduciary duty to manage the investments in a sound and prudent manner, in line with Sharīʿah requirements and participants' expectations." http://www.bnm.gov.my/guidelines/06_others/Concept%20Paper%20-%20Guidelines%20on%20Takaful%20Operational%20Framework.pdf. Accessed on 10th April 2010.

[3] See http://www.bnm.gov.my/index.php?ch=8&pg=14&ac=1511&print=1. Accessed on 25th April 2009

on a percentage of contribution paid. However, the operator's remuneration may include a performance fee charged against any surplus, as an incentive to manage the *takāful* fund effectively. Some contemporary scholars who allow the sharing of surplus between the policy holders and the *takāful* operator regard it as a *juʿalah* for the management's good performance in handling underwriting.[4] Most *takāful* operators around the world are charging a fee for their good performance in underwriting, payable from the underwriting surplus. This is against AAOIFI standards on *takāful* where shareholders of *takāful* operators are not allowed to share the surplus with the participants.

4. MUḌĀRABAH MODEL

In a *muḍārabah* model, the *takāful* operator acts as a *muḍārib* (entrepreneur) and the participants are *rabb al māl* (capital providers). The contract specifies how the investment profit and/or surplus from the *takāful* operations are to be shared between the *takāful* operators and the participants. Losses are borne solely by the participants as the providers of capital on the condition that the operator is free from any misconduct and negligence, and in that case the *muḍarib* is not entitled to receive any compensation for his efforts.[5] This model was the earliest model introduced by some *takāful* operators in Malaysia after the introduction of the Takaful Act 1984.

By this principle, the *takāful* operator will accept payment of the *takāful* contributions from *takāful* participants. The contract specifies how the underwriting surplus is supposed to be shared between the participants as the providers of capital and the *takāful* operator as the entrepreneur. This is done at an agreeable profit sharing ratio in accordance with the principles of *muḍārabah*. The operation of *takāful* may thus be envisaged as a profit-sharing business venture between the *takāful* operator and the individual members of a group of participants. This structure was also known as modified *muḍārabah*. [6]

There has been a lot of criticism against this model. Among others, it has become much more in favour of the operators who are always in a winning situation where they can share the surplus with the participants according to the *muḍārabah* profit sharing ratio. This model is definitely against AOOIFI standards on *takāful*. The irregularity lies in the distribution of the underwriting surplus from

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[4] Author's interview with Sheikh Abd al-Sattar Abu Ghuddah at International Islamic University Malaysia, 6 March 2008.

[5] See Islamic Financial Services Board (IFSB) and International Association of Insurance Supervisors (IAIS), 2006.

[6] http://www.takaful-malaysia.com/V5/index.php?option=com_content&task=view&id=24&Itemid=161.

the *tabarru*ʿ fund since surplus is actually the remaining capital, not the accrued profit.

5. WAQF MODEL

This model is applied in Pakistan and South Africa. The operator or participants will establish a *waqf* entity with their preliminary contribution. This is to create a legal entity for the *waqf* fund which will be responsible to collect donations and to give a protection and indemnity to the participating members on behalf of themselves. Any contributions which are in the form of premiums shall belong to the *waqf* fund. The same is true with the yields of the investment. The proceeds will be used to pay claims and compensations to the members facing any unfortunate events.[7] In this model, the *takaful* operator will act as the *waqf* manager who is entitled to receive payment for the services rendered.

6. SHARĪʿAH PRINCIPLES FOR MANAGING INVESTMENT PORTFOLIOS

Funds can be managed either on *muḍārabah* basis or on agency basis. When funds are managed on mudarabah basis, the management fee of the *mūḍarib* is specified as a share of the profit made by the fund. If, on the other hand, the funds are managed on agency (*wakālah*) basis, management fee is specified for the agent as a fixed amount or as a percentage of the amount underwritten, which eventually becomes a lump sum or a percentage of the net asset value. This form is considered permissible by some jurists, on the basis that it is analogous to a sale agency fee which is based on a percentage of the price. Another form that combines the two methods is when the manager receives a basic fee plus a specified performance fee based on a certain hurdle rate of return being achieved.[8]

7. INVESTMENT LINKED TAKĀFUL

An investment-linked *takāful* is commonly a Family *Takāful* plan that combines investment and *takāful* coverage. This product is known in conventional insurance as investment-linked insurance. It is defined as a life insurance that combines investment and protection. The premiums provide not only a life insurance cover but part of the premiums will also be invested in specific investment funds of

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[7] Taqi Usmani, 2005, pp. 11-20. See also Abu Ghuddah, 2008a, vol. 9, p. 287. See also Abu Ghuddah, 2008b.

[8] See Accounting, Auditing and Governance Standards for Islamic Financial Institutions, 1424-5H/2003-4, Manama, Bahrain, Jun 2003, Financial Accounting Standards for Investment Fund, p. 422.

customers' choice.[9] Similarly, as far as investment-linked *takāful* is concerned, the contributions of the participants will be divided into two parts. One part is to serve protection where a particular portion of the contribution will be treated as donation to the fund. This portion is used to help the participants that need it most, as in the case of death or disability. The other portion of the contribution goes into buying investment-linked units. The customers are given the chance to choose which *Sharīʿah* approved investment funds they want to invest in. The investment-linked units are then managed by the *takāful* operator, who in return receives a fee (*ujrah*) for the service. If, during the period of *takāful,* no claim was made, the participants-cum-investors will receive a share of the surplus in the *takāful* fund, based on the pre-agreed ratio with the *takāful* operator. Each share of the surplus will be used to purchase additional investment-linked units.[10]

Investment-linked business is defined in Section 7(2) (b) of the Insurance Act as, "The effecting and carrying out of a contract of insurance on human life or annuity where the benefits are, wholly or partly, to be determined by reference to the value of, or the income from, property of any description or by reference to fluctuations in, or in an index of, the value of property of any description".

Bank Negara Malaysia has issued "JPI/GPI 33- The Guidelines on Investment–Linked Business" which took effect by December 2005. The guidelines cover a wide spectrum of the operations and administration of investment-linked business. They aim to facilitate the orderly development of investment-linked business with prudential standards of corporate governance. They also aim to maintain and improve the professionalism of insurers and their intermediaries in both the administration and sales of investment-linked business to ensure fair treatment to policy owners.

The supervisory authority requires insurers to comply with standards on investment activities. These standards include requirements on investment policy, asset mixing, valuation, diversification, asset-liability matching and risk management. For a *takāful* undertaking, the *Sharīʿah* board plays a key role in setting standards for the types of assets in which the *takāful* operator can invest, and standards for choice of assets within an asset class. These standards are in addition to regulations or guidance from the regulators.[11]

8. PRODUCT FEATURES[12]

[9]http://www.insuranceinfo.com.my/choose_your_cover/secure_your_future/investment_linked_insurance.php?intPrefLangID=1&. Accessed 10th April 2010.
[10]http://www.insuranceinfo.com.my/choose_your_takaful/things_to_note/investment_linked_takaful.php?intPrefLangID=1&#content1. Accessed 19/04/2009.
[11] Ibid.
[12]http://www.ambg.com.my/personal/depositinevestments/fdinvestments/amhightakafulinvestmentlinkedp., and http:www.takaful-ikhlas.com.my/familyTakaful/basis Premier investment linked asp. Accessed 20/04.09

Takāful investment-linked products provide a means of investment with proper financial protection. Participants can choose a suitable plan according to their needs which can be in the form of regular monthly contributions, or one contribution. A portion of the contribution goes to the *tabarru*ʿ fund and the other portion goes to the investment fund. Sometimes, there is a requirement of the minimum amount of lump sum and regular contribution with different periods of maturity. It is more towards an investment plan than getting protection. The fund can be close-ended or open-ended, and can be a short or long term maturity investment.

In the event of the death of a participant, the *takāful* operator on behalf of the *tabarru*ʿ fund pays the beneficiary the *takāful* death benefit, plus his or her share from the investment account. If the insured survives to the maturity period of the policy and meets the targeted amount (sum assured) of savings that he or she determined at policy inception, the insured gets the refund of the net asset value (NAV) of the accumulated units in the investment fund. These accumulated units represent his installments minus his contribution to the *tabarru*ʿ fund, plus his or her share from the generated income from that account. In addition, he or she is also entitled to get proceeds from the surplus of the *tabarru*ʿ fund.

In case of early surrender, the *takāful* operator will refund all the proceeds from the investment account plus his or her share of surplus from the *tabarru*ʿaccount (if any), minus administrative expenses and other related charges at the date of surrender.

The *takāful* operators offer their customers a choice of three *Sharī*ʿ*ah*-compliant investment options that suit their personal risk profile: Fixed income Fund/Conservative Investment Profile; Balanced Investment Profile and Growth Investment Profile. Participants are also given flexibility to switch between investment options (with or without a fee) at any time, or choose a combination of the two mechanisms and make partial withdrawals and early encashment. They are also entitled to annual *tabarru*ʿ fund surplus distribution (if any), proportionate to their contribution. The participants are automatically covered with a supplementary *takāful* benefit in case of death or total and permanent disability (TPD) prior to maturity. The benefits payable in the event of a participant's death or total and permanent disability before maturity date of the certificate will be the higher of (a) *Takāful* benefits with 125% of the single contribution, plus top-up amount, less withdrawals, or (b) Accumulated fund value in all unit funds. Upon maturity of the certificate term, the Net Asset Value (NAV) of the units in the Unit Fund attached to the certificate are payable. The NAV of units in the Unit Fund are calculated on the first valuation day following the maturity date.[13]

Some *takāful* investment-linked products only accept one lump sum contribution. One such product is *my* Al-Afdhal introduced by Takāful Malaysia in

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[13] Ibid.

2008. It is a five-year closed-ended investment-linked plan that allows participants to invest in a *Sharīʿah*-compliant structured investment product. With its principal protected feature, participants will enjoy protection throughout the term whilst gaining investment return in the form of Annual Profits from their lump-sum Single Contribution.

Subject to the actual performance of the investment, the returns on the structured product investment will be based on the performance of the reference assets whilst the principal will only be protected if investment is held to maturity. Being an Islamic structured investment-linked product that focused on strategy and linked to global multi asset classes (equities, commodities and bonds), the product was specifically designed to cater to the needs of individual and corporate investors seeking for alternative capital protected *Sharīʿah*-compliant investment combined with Takaful Protection.[14]

Another example of single contribution investment-linked plan is Ikhlas Capital Investment Linked Takaful offered by Takaful Ikhlas Malaysia. It is a plan that provides both capital appreciation and protection at the same time. There are three types of funds for the investor to invest in, namely Growth Fund**,** Balanced Fund and Fixed Income Fund.[15]

Some *takāful* operators offer *takāful* investment-linked products by giving participants a chance to choose from two *Sharīʿah*-compliant investment strategies, i.e. cash such as *ṣukūk*, commodity *murābaḥah* and other *Sharīʿah*-compliant money market instruments or equities, which are *Sharīʿah*-compliant securities and Islamic mutual funds.[16]

The *takāful* operator, who is the manger of the funds, manages the fund *in trust* for the participants. The investment portion can be much bigger compared to the *tabarruʿ* portion. Sometimes the investments are the aim and not the protections. Some institutional investors would request the *takāful* operators to structure and design a tailor made investment fund which suits their needs, to the extent that sometimes only a small portion of the lump sum contribution is allocated to the protection (*tabarruʿ* fund). In this case a *takāful* operator is acting as a fund manager or a broker, financial planner or advisor for the investment.

According to Engku Rabiah, prospects of *takāful* funds are bright, especially with the more competitive environment created by the emergence of many new *takāful* companies. She proposed and suggested how to improve the prospects of

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[14] Takaful my al-Afdhal Capital Protected Investment Plan. Annual Performance Review 2008/2009 Takaful Malaysia. Website: www.takaful-malaysia.com.

[15] http://www.takaful-ikhlas.com.my/familytakaful/basicCapital.asp. Accessed on 14th April 2010.

[16] This product is offered by Dubai Islamic Bank. See http://www.alislami.ae/en/personalbanking_takafulTakafulprogramme.htm., Accessed 20/04.09

takāful funds among others, to create more regional or global investment-linked *takāful* funds with customer-centric approach that offers many diversified and individually customized product features for better customer attraction and satisfaction.[17] The other means is to diversify investment of *takāful* funds outside the country of residence such as in the regional or global market in order to generate higher returns. Return on investment (ROI) can be limited if not enough diversifications are made. For example, the ROI of Family *Takāful* funds in Malaysia between 2003 to 2007 ranges from 4.3% to 4.4% only.

List of Takaful Investment Linked Unit Trust Prices as of 07/03/2009

	Takaful Operator	Name of Fund	Buy	Sell	NAV (RM)	Date
1	Takaful Malaysia	Tabung Istiqrar	1.12	1.18	1.12	02/03/09
2	Takaful Malaysia	Tabung Ittizan	1.09	1.14	1.09	02/03/09
3	Takaful Malaysia	Takaful my Al-Afdhal	-	0.92	0.93	02/03/09
4	Takaful Ikhlas	IKHLAS Fixed Income Fund	1.012	1.012	1.012	02/03/09
5	Takaful Ikhlas	IKHLAS Balanced Fund	0.872	0.872	0.872	02/03/09
6	Takaful Ikhlas	IKHLAS Growth Fund	0.784	0.784	0.784	02/03/09
7	Takaful Ikhlas	AmHigh Islamic Cash Strategy	1.005	1.005	1.005	02/03/09
8	Takaful Ikhlas	AmHigh Islamic Equity Strategies	1.005	1.004	1.005	02/03/09
9	PruBSN	Takafulink Dana Ekuiti	0.883	0.883	0.883	02/03/09
10	PruBSN	Takafulink Dana Bon	1.073	1.073	1.073	02/03/09
11	PruBSN	Takafulink Dana Urus	0.923	0.923	0.923	02/03/09
12	Hong Leong Tokio Marine Takaful	HLTMT i-Income Fund	1.036	1.036	1.036	27/02/09
13	Hong Leong Tokio Marine Takaful	HLTMT i-Balanced Fund	1.007	1.007	1.007	27/02/09
14	Hong Leong Tokio Marine Takaful	HLTMT Capital Protection Investment Linked Fund	0.973	0.973	0.973	27/02/09
15	Hong Leong Tokio Marine Takaful	HLTMT Gulf Opportunities Plan Fund	0.985	0.985	0.985	27/02/09
16	MAA Takaful	Shariah Balanced Fund	0.396	0.396	0.396	27/02/09
17	MAA Takaful	Shariah Income Fund	0.502	0.502	0.502	27/02/09
18	MAA Takaful	Shariah Growth Fund	0.345	0.345	0.345	27/02/09

[17] Engku Rabiah Adawiah Engku Ali and Hassan Scott P. Odierno, 2008 , pp.157-8.

19	MAA Takaful	Takafulink Structured Invest Fund	0.500	0.500	0.500	27/02/09
20	Prudential	PRUlink Dana Unggul	1.452	1.452	1.452	02/03/09
21	Prudential	PRUlink Dana Aman	1.657	1.657	1.657	02/03/09
22	Prudential	PRUlink Dana Urus	1.538	1.538	1.538	02/03/09
23	Prudential	PRUlink Dana Urus II	1.033	1.033	1.033	02/03/09
24	Etiqa Takaful	TAKAFUL Capital Protection I	1.038	-	1.038	23/01/09
25	Etiqa Takaful	TAKAFUL Capital Protection II	1.068	-	1.068	23/01/09
26	Etiqa Takaful	TAKAFUL Capital Protection III	1.000	-	1.000	23/01/09
27	Etiqa Takaful	TAKAFUL Capital Protection IV	0.962	-	0.962	23/01/09
28	Etiqa Takaful	TAKAFUL Al-Waqi	0.972	-	0.972	23/01/09
29	Etiqa Takaful	Muamalat Capital Protection Plan (MCPP)	1.017	-	1.017	23/01/09
30	CIMB Aviva Takaful	Islamic Growth Fund	0.997	1.049	0.997	27/02/09
31	CIMB Aviva Takaful	Islamic Balanced Fund	0.990	1.042	0.990	27/02/09
32	CIMB Aviva Takaful	Takaful Global Giant (TGG)	0.957	-	0.957	27/02/09
33	CIMB Aviva Takaful	Market Select 3	0.973	-	0.973	26/02/09
34	CIMB Aviva Takaful	Market Select 5	0.943	-	0.943	26/02/00
35	HSBC Amanah Takaful	NEAT	1.042	-	1.042	02/03/09
36	HSBC Amanah Takaful	Wellness	1.010	-	1.010	02/03/09
37	HSBC Amanah Takaful	Essentials	0.995	-	0.995	02/03/09
38	HSBC Amanah Takaful	Neat 2	0.992	-	0.992	02/03/09
39	HSBC Amanah Takaful	LifeSelect Fixed Income	1.010	1.010	1.010	27/02/09
40	HSBC Amanah Takaful	LifeSelect Equity	0.869	0.869	0.869	27/02/09

Source: http://janganterlepaspandang.wordpress.com/Takafulinkmalaysia/. Accessed on 14/04/2010

<u>Shariah Investment-Linked Insurance Funds in Non- Takaful Insurance Companies</u>

Shariah Investment-Linked Insurance Funds (SILIF)	Insurance Company (Non- Takaful)
MCIS Shariah fund	MCIS Insurance Berhad

Shariah Malaysia Equity	Mayban Life International(Labuan) Ltd.
Dahlia Shariah Income Fund	Mayban Life Assurance Berhad
MAA Dana Assalam MAA Dana Alfayyadh	Mayban Assurance Alliance Berhad
Prulink Dana Rasulmal Prulink Dana Sanad Prulink Dana Idarah	Prudetial Assurance Malaysia Bhd.
Lion Barakah Fund	Great Eastern Life Assurance
AIA Dana Alisthithmar AIA Dynamic Shariah Fund	American International Assurance
HLA Venture Dana Iltizam	Hong Leong Assurance Bhd
Shariah Growth Fund	AML Assurance Bhd

Source: Rosly, 2005, p. 494. Note: Some of the insurance operator already got *takāful* license such as Prudential Takaful Malaysia.

9. SHARĪʿAH ISSUES

It is observed that most of the contemporary scholars discussed the structure of *takāful* with the absence of the investment-linked products. They suggest it as *iltizam bi al-tabarruʿ*, *waqf*, or a contract of *taʿāwun* (mutual cooperation)[18], where in all cases the participants are bound to make contribution and the *takāful* fund is duty bound to provide protection with the sum assured. If there is any surplus, the policyholders are also entitled to get it back. All the structures are to serve the original concept of *takāful*, not on securing profit from investments. It should be born in mind that investment-linked *takāful* and most of the latest *takāful* models provide a means of investment where installments or lump sum contributions shall be divided into investment and *tabarruʿ*. As such, it is not sufficient to have only a

[18] Yusuf al-Shubayli opines that *takāful* underlying contract is neither *tabarruʿ* nor *muʿwaḍa* but a new contract of *taʿawun* (mutual assistance and solidarity). See al-Shubayli, 2008, pp.7-8.

*tabarru*ʿ or mutual cooperation contract of *takāful*. The investment contracts such as either *muḍārabah* or *wakālah bi al-ajr* should also be concluded separately.

9.1 Contractual Relationship

The contractual relation between the customers, the *takāful* operator, and the fund manager in the case of outsource, should be clearly defined. How much is the fee charged upfront? How much goes to the *takāful* agent? How much goes to the *takāful* operator and how much is charged by the investment-linked fund manager? Most of the participants-cum-investors do not know about contracts which bind them with the *takāful* operator or the third party fund manager. It is very important to know who is who in the contract. Who is the owner of the fund? The *takāful* operator should also know that he or she is managing the funds of the participants on trust as a *wakil* (agent) only, because the fund does not belong to him/her. Since the contract is based on *yad amanah* (on trust basis), they are responsible for compensating any loss or damage resulting from their negligence.

This is because the contractual relationship between the participants and the *takāful* operator is a *muʿāwaḍa* contract. The nature of a *wakalah bi ajr* (agency with fee) contract in Islamic *Fiqh* according to the majority of jurists is a contract of *muʿāwaḍah* which should be concluded with mutual consent,[19] as any uncertainties or ignorance cannot be tolerated. Meanwhile, the contract among the participants themselves is *tabarru*ʿ (benevolent donation) and *taʿāwun* (mutual cooperation). In this case uncertainties of claims, and how much of each participant's contribution to be channeled to the members in need can be tolerated.

9.2 Transparency in Charging Fees

Based on the rules of *wakālah bi ajr* (agency with fee), the contract becomes binding as it becomes a contract of *ijarah* (hire). This rule is applicable for charging the managerial fee on both investment and *tabarru*ʿ funds. It is a condition of a valid agency contract that the quantity of the task be made known (no uncertainty).[20] This also applies to the commissions paid to the agent who markets the *takāful* investment product.

9.3 Guaranteeing a Return

As far as investment linked *takāful* is concerned, the *takāful* benefit or sum covered is guaranteed by the *takāful* operator on behalf of the *tabarru*ʿ fund. This sort of guarantee can be tolerated as it is the objective of the *takāful* contract that all participating members agree to assist each other when facing an unfortunate event. However, there will be a *Sharīʿah* issue if upon maturity the participants will get a fixed return amount or the total accumulated premium installments. For the former, it is against the principles of the *Sharīʿah* to make a binding promise for a

[19] Qarah Daghi, 2008, pp. 223-4.
[20] Ibid

fixed return of an investment whether it is based on a *muḍārabah* or *wakālah* instrument. For the latter, it is as if the participants were giving a loan to a *takāful* fund. What happened to the fees and the *tabarruʿ* he made? Normally the *takāful* operator will state in the prospectus of the product that the return of the investment is not guaranteed although the performance figure will be very attractive.

The Sharīʿah Advisory Council of Bank Negara resolved that the application of *wakālah bi al-istithmar* (agency for investment) contract in a deposit account is permissible. However, the implementation of such a contract must be carried out prudently to avoid any element of guarantee by the agent on the investment returns.[21]

9.4 Regulatory Reserve

Some financial institutions or even investment fund managers use Profit Equalization Reserve (PER) as a mechanism to mitigate the fluctuating rates of return arising from flux of income, provisioning, and total deposits, to ensure the rate of return remains competitive and stable. It also aims at securing the capital from unexpected future losses for the benefit of the investors. The PER is extremely important in managing investments to maintain the adequacy and stability of the fund. The management will collect part of the gross profits of the investments and put it in the reserve in order to protect the capital without getting agreement and approval from the investors.

The PER is appropriated out of the total gross income and is shared by both the investors and the *muḍārib*. This raises a question, whether this profit equalization complies with the *Sharīʿah* since it is deducted from the gross profit before the distribution without stating this upfront in the contract. Likewise, investment risk reserve is the amount appropriated by the Islamic bank out of the income of the investment account holders. The appropriation is done after allocating the *muḍārib*’s share, in order to cater against future losses for investment account holders. The investors’ understanding and consent are necessary. AAOIFI standard states that reserves are recognized when the management of the Islamic bank decides, with the approval of investment account holders, to set up a profit equalization reserve and/or an investment risk reserve.[22]

However, some contemporary scholars oppose the idea of charging the investors from their profits for the reserves. The fund manager can only cut from his portion of the profit to be placed in the reserve. [23] It is argued that the the manager’s contribution in the reserves will violate the *muḍārabah* or *wakālah* as

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[21] http://www.bnm.gov.my/index.php?ch=8&pg=14&ac=1511&print=1.Accessed on 25th April 2009.

[22] Accounting, Auditing and Governance Standards for Islamic Financial Institutions 2003-2004, Financial Accounting Standard no 11, Provisions and Reserves, 3/1, 3/2.

[23] Tayyar, n.d., p.306.

this is similar to guaranteeing the capital or the profit. It is also worth prescribing that the reserve fund is not owned by the *muḍārib*, rather it should be channeled to charity in case of liquidation of the fund, provided they are not exhausted by their own objectives.

9.5. Charging Fee for *Muḍārabah*

Another possible issue is that the *takāful* operator or the fund manager might charge a fee for the *muḍārabah* based investment. Most of the jurists do not allow the *muḍārib* to charge a fee for services. He or she is entitled to get a portion of the generated profit according to the agreed upon profit sharing ratios. Imam al-Shafiʿī has not allowed for the *muḍārib* to spend his daily expenses from the *muḍārabah* capital except with the mutual consent of the capital provider (*rabb al-māl*). This is because since the *muḍārib* was entitled to a particular share of the profit, he has no right to use from the expenses account of the *muḍārabah*. If he does so then it's considered as taking additional profits in *muḍārabah* businesses. [24] However, Ḥanafi jurists and Imam Malik restrict this right of the *muḍārib* to spend from *muḍārabah* expenses only to a situation where he is on a business trip outside his own city or spending in the course of the business.[25]

It is stated in the AAOFI standards that a combination between profit sharing and charging a fee for the *muḍārib* is against the principle of *muḍarabah*. However, it is allowable to charge fees for other services which are not part of *muḍaraba* and are executed in an independent contract. In this case the *muḍarabah* contract continues even though that particular service contract ceases.[26] This is exactly what happens in *takāful* as the operator is already charging the management fee upfront, he is no longer entitled to charge a fee on the *muḍārabah* fund for conducting business as he will get his reward from the profit.

9.6. Investment Avenues

Among the investment avenues is to invest in Islamic debt securities as this as allowable according to the Malaysian Securities Commission standards, which issues a list of permissible stocks twice a year. The majority of the Middle Eastern scholars do not allow this. While there are different standards to screen shares such as FTSE Sharīʿah Global Equity Index Series, Dow Jones Islamic Market Indexes, AAOIFI and Malaysian Securities Commission, the Sharīʿah advisory council of each *takāful* operator should decide on the standards used for screening.

The sale of debt is one of the key elements in the development of the Malaysian Islamic Capital Market (ICM), as the trading of Islamic bonds or commercial papers in the capital market is mainly based on *bayʿ al-dayn*. The Malaysian scholars who are sitting on the Sharīʿah advisory council of Bank Negara Malaysia

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[24] Al-Shirazi, *al-Muhadhab*, volume 1,p.386.
[25] Al- Sarakhsi, *al-Mabsut*,volume 22,p.63.
[26] AAOFI standard no 8/2

and the Securities Commission of Malaysia allowed the trading of debt. On the other hand, the majority of the scholars around the world and particularly the jurists from the Middle East, oppose the permissibility of *bayʿ al-dayn*. The main grounds for its impermissibility as argued by opponents is due to the elements of *gharar* and *ribā*. Whereas the advocates claim that in the context of modern practice of *bayʿ al-dayn* in the capital market, these two major prohibitions in Islamic finance (*gharar and ribā*) could be eliminated.

Bayʿ al-dayn is technically defined in different ways. The Sharīʿah Advisory Council of Securities Commission in Malaysia provided a specific definition of *bayʿ al-dayn* as being practiced in Malaysia. According to the Council, "In the context of the Islamic capital market, *bayʿ al- dayn* is the principle of selling debt which results from exchange contracts, such as *murābaḥah*, *bayʿ bi thaman ajil* (BBA), *ijārah*, *ijārah munthiyah bi tamlik*, *istiṣnaʿ* and others".[27]

Resolutions of the Securities Commission Sharīʿah Advisory Council stated that: "The argument of the Islamic jurists that prohibited *bayʿ al-dayn* to a third party for fear that the buyer will have to bear great risks (Ḥanafi school) has some truth in it. This is especially true if there is an absence of supervision and control. In this context, the buyer's *maṣlahah* should be safeguarded because he is the party that has to bear the risks of acquiring the debt sale while making the sale contract. In the Malaysian context, the debt securities instruments based on the principle of *bayʿ al-dayn* are regulated by Bank Negara Malaysia and the Securities Commission to safeguard the rights of the parties involved in the contract. Therefore, the conditions set by the Maliki school and the fears of risks by the Ḥanafi school can be overcome by regulation and surveillance."[28]

Another important issue is that of *ribā* when debt securities are traded in the secondary market at a discounted price. *Ribā* might arise due to the rule of parity in the exchange of money with money in the same denomination. However, it is claimed that there is no *ribā* element involved and the rule of parity does not apply "in the [Malaysian] context of the sale of securitized debt, [where] the characteristics of securities differentiate it from currency, and hence, it is not bound by the conditions for exchanging goods."[29]

However, these arguments were rejected by the majority of contemporary scholars. For example, Mufti Taqi Usmani has clearly pointed out that *bayʿ al-dayn* is in fact selling a *ribāwi* item with a discounted price, which definitely amounts to *ribā al- fadl* and *ribā al-nasi'ah.* He stated that "In fact, the prohibition of *bayʿ al-dayn* is a logical consequence of the prohibition of *ribā* or interest. A 'debt' receivable in monetary terms corresponds to money, and every transaction where money is exchanged from the same denomination of money, the price must be at

[27] Securities Commission Malaysia, 2007, p. 16.
[28] Ibid. p. 19.
[29] Ibid. See also Engku Rabiah Adawiah Engku Ali, 2008, pp. 482-4.

par value. Any increase or decrease from one side is tantamount to *ribā* and can never be allowed in *Sharīʿah*". [30]

One may argue that if it is only to sell the debt to the third party at par without any expectation of return as a compensation/reward for waiting until the debt matures surely will not be attractive enough for the third party to buy the receivables, especially since at the same time the third party has to assume the risks of default. The trading of debt involves the theory of money being equal to time, or time value of money. In general, for *murābaḥah* deferred term sales, time can be taken into account in the pricing because of the associated risks involved, but the price should be fixed and known to the contracting parties, and the price will not increase or decrease. In the case of debt trading, it is without a doubt the exchange of money for more money, which is not allowed except at par.

One can also suggest that the debt trading is also not allowable on the basis of *zid wa ta'ajjal*, i.e. "You add the outstanding amount in consideration of deferment of the settlement". Likewise in this context, "I pay my money for the higher consideration because of the deferment of the settlement; the longer the period of delay, the higher the increment I get on my money." This was a normal commercial practice among the Arab tradesmen of Mecca during the pre-Islamic period and was later prohibited by the Prophet (peace be upon him).

As far as the investment-linked *takāful* is concerned, it is suggested to exclude the tradable debt securities from the investment asset portfolios. Alternatively, if it were to subscribe debt securities, then it should be a close ended *ṣukūk* which is held to maturity.

9.7. Purification of Returns

Purification of returns is basically the act of deducting the non-*ḥalāl* "tainted income" which is not acceptable from the *Sharīʿah* point of view, from the total returns on investment. The main sources of returns on investment which must be cleansed are dividends and capital gains.[31] For the Muslim investors, it is their obligation to make sure that their *ḥalāl* income comes from *ḥalāl* sources. If there are some non-*ḥalāl* elements, they should be removed by donating the non-*ḥalāl* to charities.

For the time being, there has been no international *Sharīʿah* standard over the requirement of cleansing the tainted income or the mechanisms to cleanse the non-*ḥalāl* returns. Some jurisdictions or particular Islamic financial institutions require the purification/cleansing of the non-*ḥalāl* income. The Securities Commission of Malaysia in its investment guidelines is silent about this. This is perhaps by taking into consideration the fact that not all investors are Muslim. Nevertheless, the act or initiative to cleanse can be done either by the fund manager or individual

[30] Taqi Usmani, 2002, p 100.
[31] Engku Rabiah Adawiah Engku Ali and P.Odierno, Hassan Scott, 2008, p.157.

investor. Generally, the returns are cleansed by causing a portion of the dividends/ capital gains equivalent to the percentage of "tainted" income to be donated to charities.

There is a legal maxim mentioned by Ibn Taimiyyah,

"من اختلط بماله الحلال والحرام أخرج قدرالحرام، والباقي حلال له"

"If *ḥalāl* mixes up with *haram*, provided that the *haram* portion is cleansed, the rest is *ḥalāl*."[32]

There is another legal maxim, "When the *ḥalāl* items are mixed up with the *haram* items they are considered as *harām*". This is applied to the mixed items of *ḥalāl* and *harām* which are inseparable constructively or physically, for example in the case of the mixture of slaughtered animal and non- slaughtered. As for separable items such as money, the *ḥalāl* and *haram* portions can be separated by taking out the *haram* portion. The reason for this is because what makes it *haram* here is not the very item itself but rather the external factors. In other words, it becomes *haram* because of prohibited acts or violation of the *Sharīʿah* rules in generating the income either by *ribā* or stealing.

According to Ibn Taimiyyah, *harām* mixture can be divided into two major classifications:

1- What is *ḥarām*/ prohibited in itself such as the meat of a dead animal which is not slaughtered. If it is not specific, such as one knows that someone is selling the meat of a carcass in the market and he does not know which one is *ḥalāl* and which is *ḥarām*, in this case it is not *ḥarām* to purchase the meat. In the case that he is uncertain between a specific mixture between the slaughtered and non-slaughtered (carcass), then he is not allowed to buy any of the two.
2- What is prohibited because of external factors such as stealing or what is possessed via invalid contract such as *ribā* or gambling. In this case, if they are mixed up with *ḥalāl* and *ḥarām* the mixture is not *ḥarām*, but the *ḥarām* portion should be removed.

The repentance for those who have a mixture of *ḥalāl* and *ḥarām* assets is to channel the *ḥarām* portion or its value to charity.[33] In addition, such assets should be purified to avoid future occurrence of such *ḥarām* business or assets. If the manager does not purify the non-*ḥalāl* income, then he should announce to the Muslim investors about the percentage of non-*ḥalāl*.

9. 8. Takaful Investment-Linked Products Offered by Conventional Insurance Operators

32 al-Nadawi, 2000, vol. 1, p.398.
33 Ibn Taymiyyah, 1991, vol. 22, p.142.

It has been declared impermissible by the Malaysian National Fatwa Council for a Muslim to subscribe to investment-linked products associated with the conventional insurance protection scheme offered by conventional insurance companies since there are a lot of alternatives in the market to buy *Sharīʿah* compliant investment products offered by *takāful* operators.[34]

One may argue that the reason for the prohibition lies in the fact that the investment-linked products are not stand alone, but rather associated with the protection of the operator. Thus the nature and contract of protection does really matter.

CONCLUSION

Takāful, like the conventional insurance industry is no longer constrained to providing protection, but is now an avenue for investment opportunities. Customers are participating in *takāful* schemes, especially the investment linked products because of the attractive features (i.e. combination of protection and investment). Apart from the purpose of solidarity (*takāful*), and giving rewards from the donation (*tabarruʿat*) to the members in need, the participants can also generate profit from their investments. But these two contracts are of different natures and should be concluded separately.

A *takāful* operator can charge fair[35] fees for the *tabarruʿ* portion which can be treated as a non-commercial venture, and as for the investment portions, the operator can either charge a fee as a broker or a manager of investment funds, or share profit with the member investors.

If the manager of the investment fund does not purify the portion of the non-*ḥalāl* income of the investment, then the Muslim investors should be informed about the percentage of non-*ḥalāl* income so they can purify it by themselves. Alternatively, for the purpose of purification, the *takāful* operator may set up a special charity fund to be channeled to the public for the charity avenues, not for the interest of the participation members. This cannot be treated as part of the operator’s corporate social responsibility.

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[34] Keputusan Muzakarah, Jawatankuasa Fatwa kebangsaan, siri 3, Jabatan Kemajuan Islam Malaysia, 2009, Pg.27
[35]See Qurrah Daghi, 2005 pp. 330-1

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