

Principles and Practices of Islamic Insurance

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PRINCIPLES AND PRACTICES OF ISLAMIC INSURANCE

Khalifa M Ali Hassanain

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Course 6: Chapter 1

Chapter Introduction

Overview of Economic Risk.

The term risk cannot be explained with a single definition because it differs based on origin, scholars etc. All executives, employees, investors, students, householders, travellers and farmers confront risk and deal with it in various ways.

Though many people consider the terms risk and uncertainty interchangeable, they differ in meaning. Risk refers to statistically predictable occurrences, while uncertainty refers to an unknown of generally unpredictable variability.

The broad perspective on risk and its management are embodied in the overall goals of Islamic law or *Maqasid Al-Shari'ah*. Al-Ghazali defines Islamic law as a promotion of well-being of the people to safeguard their faith, self, intellect, posterity and wealth. From an Islamic perspective all economic activities are not measured based on their inherent risk factors but their impact on value or wealth.

Financial institutions have to manage multiple risks, which include credit risk, liquidity risk, operational risk and market risk.

At the end of this chapter, you will be able to:

- Explain the concept of risk according to reputed scholars,
- Distinguish between the terms risk and uncertainty,
- Explain the components of risk and its associated terms,
- Describe the broad classification of risk,
- Describe the Islamic perspective of risk and management and
- Explain the nature of risks faced by financial institutions.

What is Risk?

Risk can be defined in different ways based on its origin.

In Arabic, *risq* refers to working to gain income gain and profit.

A Greek derivative of the word *risq* refers to the chance of outcomes in general and it has neither positive nor negative connotations.

The French word *Risque* has mainly negative connotations but occasionally positive.

The English usage of the word *risk* has definite negative associations.

The Latin usage of *Risqum* refers to a challenge that has connotations of equally fortuitous but unfavourable event.

In literature, risk has been defined as a condition based on which the actual outcome of an event may deviate unfavourably from the expected or desired outcome. Another way of defining risk is uncertainty, which creates both opportunities and threats for individuals as well as businesses. One more way of defining the risk is uncertainty or lack of predictability; it concerns values which may be lost or not gained and it is the variation in possible results which causes risk occurring in so many situations.

Risk vs. Uncertainty

Though many people consider risk and uncertainty as interchangeable, they have different meanings. Risk refers to statistically predictable occurrences, while uncertainty refers to an unknown of generally unpredictable variability.

Some scholars have portrayed the distinguishing factors between risk and uncertainty. According to them, risk is taken to have a quantifiable attribute and it has a place in the calculus of probabilities, whereas uncertainty exists in situations where decision-makers lack complete knowledge, information or understanding concerning the proposed decision and its possible consequences. The scholar noted that risk is quantifiable in nature and is measured by statistical assessment using hard data, while uncertainty is non-quantifiable in nature and is measured by subjective probability using informed opinion.

Components of Risk and Associated Terms

The four essential components of risk are probability of occurrence, severity of impact, susceptibility to change or external influence and degree of interdependency.

Some of the risk related terms include:

- Perils that refer to the causes of risk.
- Hazards that refer to conditions which increase the likelihood of risk. These can be physical, moral and legal.
- Losses that refer to undesirable end results of risk.

Classification of Risk

Risk can be classified into four types. They are speculative and pure, financial and non-financial, static and dynamic and fundamental and particular.

Speculative and Pure Risks

In speculative risks, there are chances of loss or gain, while in pure risks, there are chances of either loss or no loss.

Pure risks for individuals and business organisations can be further classified into:

- Personal risks, which include premature deaths, dependent old age, sickness or disability and unemployment,
- Property risks, which include direct loss and indirect or consequential loss,
- Liability risks, which include property damage and bodily injury and
- Risks arising from failure of others.

Financial and Non-Financial Risks

Financial and non-financial risks include all situations in which there is an exposure to adversity that involves financial or non-financial losses.

Static and Dynamic Risks

Static risks result in losses even if there are no economic changes. Examples include risks from natural calamities and dishonesty of individuals. Dynamic risks result from economic changes. Examples include changes in price levels, technology and consumer preferences.

Fundamental and Particular Risks

Fundamental risks cause losses that arise from impersonal factors and do not affect individuals. They are group risks that are mostly caused by social, economic and political phenomena. They affect a significant section of the population.

Particular risks result in losses due to individual events. These risks always affect individuals.

The Islamic Perspective of Risk

The broad perspective on risk and its management are embodied in the overall goals of Islamic law or *Maqasid -Al-Shari'ah*.

Al-Ghazali defines Islamic law as the means to promote the well-being of the people to safeguard their faith, self, intellect, posterity and wealth.

From the Islamic perspective, economic activities are not judged by inherent risks, but by the values added and/or wealth created by them. However, many sales contracts are prohibited because of their inherent uncertainty (*Gharar*).

Some of these contracts include:

- Selling non-existent assets.
- Selling goods not possessed by the seller.
- Selling goods without clear price or mode of delivery.

By not permitting such contracts, the *Shari'ah* tries to mitigate the high level of risk involved in them.

Based on this perspective, a scholar identified essential risk and prohibited risk as the types of risk. Let's learn more about each type.

Essential Risk

This risk is more prominent in all kinds of business transactions. This risk is necessary and must be undertaken to draw associated profit from the transactions.

The two legal principles that are associated with the returns of essential risk are stated below:

- *al-Ghurm bil Ghunm*: The detriment is a return for the benefit; the principle attaches the "entitlement of gain" to the "responsibility of loss" and
- *al-Kharaj bil Daman*: The benefit of a thing is a return for the liability for loss from that thing. This principle emphasises that the party enjoying the full benefit of an asset or object should bear the risks of the ownership.

Prohibited Risk

This risk is in the form of excessive *Gharar*, which relates to the ambiguity and/or ignorance of either the terms of a contract or the object of the contract. Therefore, the sale can be void due to the existence and possession of the object of sale and uncertainty of the quantity, quality, price and time of payment.

Risks Faced by Financial Institutions

A typical balance sheet of a financial institution will have the equity and deposits/debts as part of liabilities and banking and trading portfolios as part of the assets side. This gives us the indication of the nature of risks that financial institutions face.

These risks are of two types: risks related to the entire balance sheet and risks related only to the assets side. Some of the risks related to the entire balance sheet include interest rate risk, liquidity risk and exchange rate risk. Some of the risks related only to the assets side of balance sheets include credit risk, operational risk and market risk.

Let's now look at the types of risks financial institutions need to manage.

Credit Risk

This risk occurs when the counterparty defaults on its obligations with regards to time and the agreed terms due to volatility in default rates and credit qualities. Banking as well as trading books of banks often carry this type of risk.

Trading credit risk arises when a borrower fails to fulfil contractual obligations mentioned in trading contracts. This leads to settlement risk where one party delivers assets or pays money prior to receiving their cash or assets, thereby leading to a potential loss. In financial institutions, settlement risk mainly occurs in foreign-exchange transactions.

Islamic banks are exposed to distinctive kinds of credit risks due to the unique nature of Islamic financial instruments.

For example, in *Murabahah* transactions, Islamic banks face credit risks if they do not receive any payment from clients after delivering the assets. In *Bai' al-Salam* contracts, Islamic banks incur financial loss as well as capital when they fail to deliver or supply goods on time or fail to supply goods on time, at all or as per the contracts. In *Mudarabah* contracts, Islamic banks act as *Rabbul-mal* and appoint an external agent or *Mudarib*. Because they provide advance capital to the *Mudarib*, Islamic banks face an enhanced credit risk.

Market Risk

This risk originates from the instruments and assets that are being traded in markets and results from micro and macro sources.

Systematic market risk results from the macroeconomic policies and overall price trends.

Unsystematic risk occurs when a particular asset or instrument is repriced due to events that are linked to it specifically.

Volatile prices in markets causes various kinds of market risks such as re-pricing risk, currency risk, and commodity price risk, which are similar to mark-up risk, FX risk and commodity risk.

Some experts believe that market risks also include basis risk, yield curve risk, interest rate risk and equity price risk.

Liquidity Risk

This risk relates to an organisation's cash flow. It arises due to inadequate liquidity during normal operations, which reduce the organisation's ability to meet its liabilities.

This risk may occur when it is difficult to borrow cash at a reasonable cost or by selling assets.

Liquidity risk is of two types. The first type is about the lack of liquidity where a financial instrument is encumbered by liquid assets to meet its financial obligations and liabilities. In the second type, Islamic banks cannot borrow money or raise the capital at a moderate price when required.

Liquidity risk also impairs the ability of a bank to match the maturity of assets and liabilities, and to be able to perform active portfolio management.

Operational Risk

This risk occurs due to human errors, accidents and technical problems. It involves loss, direct or indirect, caused by failed or poor internal processes, technology, people or external events.

Legal risk can be considered a part of operational risk because financial contracts may not be enforceable due to legislations, statutes or regulations. This risk can be externally related to regulations affecting business activities or related internally to fraudulent employees or management.

Regulatory risk mainly occurs due to changes made in the regulatory framework of a country.

Operational risk can increase in Islamic banks due to certain aspects, such as:

- Cancellation in the non-binding *Murabahah* and *Istisna'a* contracts,
- Failure to detect and manage potential problems in the operational process,
- Difficulties in implementing Islamic contracts in a broader legal environment,
- Necessity of maintaining and managing commodity inventories in illiquid markets and
- Price and peril involved in observing equity type contracts and the associated risks.

Chapter Summary

You have completed the chapter, **Overview of Economic Risk**. The key points of this chapter are as follows:

- Risk is defined in different ways based on different origins.
- Risk refers to statistically predictable occurrences, while uncertainty refers to an unknown of generally unpredictable variability.
- Some scholars have portrayed the distinguishing factors between risk and uncertainty.
- The four essential components of risk are probability of occurrence, severity of impact, susceptibility to change or external influence and degree of interdependency.
- Risk can be classified into four types: speculative and pure, financial and non-financial, static and dynamic and fundamental and particular.
- From the Islamic point of view, economic activities are not judged by inherent risks, but by the values added and/or wealth created by them.
- From the Islamic point of view, essential risk and prohibited risk are the types of risk.
- The balance sheet of a financial organisation gives us the indication of the risks that financial institutions face and their nature.
- Some of the common types of risks faced by the financial institutions are credit risk, market risk, liquidity risk and operational risk.

Course 6: Chapter 2

Chapter Introduction

Islamic Perspective on Risk Management.

Islamic financial institutions (IFIs) were established more than thirty years ago to provide *Shari'ah*-compatible investment, financing and trading avenues that conventional financial institutions could not provide. Like in their conventional finance counterparts, one of the main functions of IFIs is effectively managing risks that arise in financial transactions.

Contemporary risk management processes and strategies have implemented various theories of risk management and numerous analytical tools. A critical factor in good risk management is understanding the risk-versus return tradeoff. Generally, investors can anticipate a higher rate of return only if they are willing to take higher risks. Since financial institutions primarily aim to give their shareholders higher returns, managing risks arising from this effort is a key function for them. Usually, they manage risks in two ways: efficiently diversify the unsystematic risk, and lower or transfer the systematic risk.

Although the main elements of risk management include identifying, measuring, monitoring, and managing various risk exposures, these cannot be effectively implemented unless there is a broader process and system in place. The overall risk management process should be comprehensive, embodying all departments and sections of the institution so as to create a risk management culture. It should be pointed out that the specific risk management process of an individual financial institution depends on the nature of activities and the size and sophistication of the institution.

Enterprise Risk Management or ERM involves managing risks that are significant for maintaining and enhancing the value of a firm. ERM mainly targets risks that could possibly cause economic damage. ERM also contributes to the economic value by reducing economic harm.

At the end of this chapter, you will be able to:

- Explain the financial risks associated with Islamic finance products.
- Explain the operational risks inherent in Islamic finance products and the approach that IFIs can adopt to mitigate these risks.
- Explain the strategic risks inherent in Islamic finance products.
- Explain the steps involved in the risk management process.
- Describe the fundamental concepts of Enterprise Risk Management.
- Explain the critical areas addressed by the ERM process.
- Explain the Islamic approach to resolving the incompatible human conflict between risk taking and risk avoidance.
- Explain the milestone concepts in the Islamic approach to risk reduction.

Islamic Finance Products - Associated Financial Risks

Islamic financial products carry certain financial risks, some of which are credit risk, liquidity risk, market risk, equity management risk and rate of return risk.

The types of financial risks are covered in detail in Chapter 1 and 3 of the course **Islamic Perspective on Risk Management**, and Chapter 3, 7 and 6 of the course **Principles and Practices of Islamic Insurance**.

Credit Risk

When a lender is exposed to loss from a borrower or a counterparty who fails to pay the debts, a potential risk arises. This is known as credit risk. This risk can occur in the banking and trading books of a bank. In the banking book, loan credit risk arises when the counterparty fails to meet its loan obligations fully in the stipulated time. This risk is associated with the quality of assets and the probability of default. Due to this risk, there is uncertainty of net-income and market value of equity arising from non-payment and delayed payment of principal and interest.

Similarly, in the trading book, credit risk arises due to a borrower's inability or unwillingness to discharge contractual obligations in trading contracts. This can result in settlement risk when one party to a deal pays money or delivers assets before receiving its own assets or cash, thereby, exposing it to potential loss. Settlement risk arises mainly in foreign exchange transactions. While a part of the credit risk is diversifiable, it cannot be eliminated completely.

Liquidity Risk

Liquidity risk arises due to insufficient liquidity for normal operating requirements, thereby reducing the ability of banks to meet their liabilities when those are due. This risk may result from either difficulties in obtaining cash at reasonable cost from borrowings or sale of assets. One aspect of asset-liability management in the banking business is to minimise the liquidity risk. While funding risk can be controlled by proper planning of cash flow needs and seeking newer sources of funds to finance cash shortfalls, the asset liquidity risk can be mitigated by diversification of assets and setting limits of certain illiquid products.

Liquidity risk also causes a compounding effect on other risks. Illiquid assets enhance market risk of an organisation. Suppose cash flows are offset by a firm with two different counterparties on the same day, but the counterparty that owes money to the firm defaults. Now the firm has to rely on other sources to raise cash to pay the other counterparty to which it owes money. If the firm is not able to do so, it will result in default and compounding of credit risk.

Market Risk

Market risk originates in instruments and assets traded in well-defined markets. Market risks can result from macro and micro sources. Systematic market risk results from overall movement of prices and policies in the economy. Unsystematic market risk arises when the price of the specific asset or instrument changes due to events linked to the instrument or asset. Volatility of prices in various markets gives different kinds of market risks such as equity price risk, interest rate risk, currency risk and commodity price risk. As a result, market risk can occur in both banking and trading books of banks.

This is evident from the following transactions:

- In *Salam* contracts, IFIs are exposed to commodity price fluctuations once they enter into the contracts and as long as they hold the subject matter.
- In parallel *Salam* contracts, any failure in the delivery of the subject matter will expose the IFIs to commodity price risk.
- In *Ijarah* contracts, the lessor faces market risk on the residual value and carrying value of the leased asset during the contract if the lessee terminates the contract early or defaults on the lease obligations.

Equity Investment Risk

Equity investment risk arises while entering into a partnership to participate in a finance contract or business activity. The bank is vulnerable to a group of risks that are connected with the *Mudarib* or *Musharakah* partner, business activity and operations.

In the profit-sharing approaches of *Mudarabah* or *Musharakah*, investment risk can be evaluated by doing due diligence of the partners. This includes the past record of the management team and business plan quality.

The involvement of IFIs in the investments during contract period creates a difference between the *Mudarabah* or *Musharakah* financings. IFIs act as silent partners in *Mudarabah* and the management acts as *Mudarib*. In *Musharakah*, IFIs invest their funds collectively and may either act as silent partners or participate in management. Neither financing mode provides a fixed return, but banks are exposed to capital impairment risks during losses.

Rate of Return Risk

This risk occurs when the returns from investment do not meet investors' expectations. This risk mainly relates to equity investments for which return is never assured and it can be measured only when the investment is sold.

A rate of return risk occurs when the IFIs are compelled to pay a higher return than the rate earned on assets that are financed by the investment account holders. IFIs may forfeit their share of profits as the *Mudarib* partially or entirely to their fund providers in order to prevent withdrawal of funds.

Displaced Commercial Risk or DCR is a result of IFIs facing competitive pressures regarding investor attraction and retention.

Some key terms in this context are as follows:

- **Profit Equalisation Reserve or PER** is the amount reserved by IFIs from their gross income before allocating *Mudarib* share so as to maintain a return on investment for the investment account holders and also to increase owner's equity.
- **Investment Risk Reserve or IRR** is the amount reserved by IFIs from the income of investment account holders after allocating *Mudarib* share in order to prevent future investment losses for the investment account holders.

Operational Risks Inherent in Islamic Finance Products

Operational risk is a broad form of risk and is associated with accidents, human errors and technical errors. It involves loss, direct or indirect, caused by failed or inadequate internal processes, technology, people or external events. While incompetence and fraud may lead to people risk, telecommunications system failure or program failure may lead to technology risk.

Process risk may occur due to errors in model specifications, inaccurate transaction execution and violation of operational control limits. Due to problems arising from inaccurate processing, record keeping, system failures and non-compliance with regulations, it is possible that actual operating costs might be different from estimated costs. This affects the net income adversely.

As operational risk can arise due to failures in people, processes, and technology, management of this risk is more complex. Senior management needs to establish the desired standards of risk management and clear guidelines for practices that would reduce operational risks. A common standard for identification and management of these risks needs to be developed to manage operational risks that arise from different sources.

The management should develop an 'operational risk catalogue' in which business process maps for each business or department of the institution are outlined. This catalogue will identify and assess operational risk and can be used for transparency by the management and auditors. It is difficult to quantify the operational risks due to their complexity. Most of the operational risk measurement techniques are simple and experimental.

The banks gather information of different risks from reports and plans that are published within the institution such as audit reports, regulatory reports, management reports, business plans, operations plans and error rates. A careful review of these documents can reveal gaps that represent potential risks. The data from the reports can then be categorised into internal and external factors and converted into likelihood of potential loss to the institution.

As there are various sources of operational risk, it needs to be handled in different ways. In particular, risk originating from people needs effective management, monitoring and controls. One important element to control operational risk is to have clear separation of responsibilities and to have contingency plans. Another significant element is to make sure that reporting systems are consistent, secure and independent of business. The internal auditors play an important role in mitigating operational risk.

The operational risks inherent in Islamic finance products are covered in detail in Chapter 3, 7 and 6 of the course, **Principles and Practices of Islamic Insurance**.

Strategic Risks Inherent in Islamic Finance Products

Strategic risks arise from influences and trends associated with macroeconomic and external factors. These risks cannot be directly controlled by a firm.

Some of the types of strategic risks are displaced commercial risks or DCR, fiduciary risks, *Shari'ah* compliance risks and reputation risks.

Strategic risks that are inherent in Islamic finance products are covered in detail in Chapters 3, 7 and 6 of this course, **Principles and Practices of Islamic Insurance**.

Displaced Commercial Risk (DCR)

Displaced commercial risk arises when banks give up a fraction of their profit share to depositors to prevent them from withdrawing their funds due to a lower return. It implies that the bank, although operating in full compliance with the *Shari'ah* requirements, may

not be able to pay competitive rates of return as compared to its peer group Islamic banks and other competitors. Depositors will again have the incentive to seek withdrawal. To preempt withdrawal, the owners of the bank will need to apportion part of their own share in profits to the investment depositors.

The AAOIFI therefore suggests that the Islamic banks' capital shall bear the risks of all assets financed by current accounts and capital. In addition, the capital shall also bear the risks of 50 percent of assets financed by the investment deposits. The risks of the remaining half of the assets financed by the investment deposits shall be borne by the investment depositors.

Fiduciary Risk

Fiduciary risk may occur due to the violation of terms and conditions of a contract by an Islamic bank. For example, a rate of return lower than the market rate also introduces fiduciary risk, if a low rate of return is interpreted by depositors and investors as a breach of investment contract or fund mismanagement by the bank. Another example is when the bank is unable to comply fully with the *Shari'ah* requirements associated with various contracts. If the Islamic bank's justification for being in business is compliance with the *Shari'ah*, non-compliance, willful or due to incapability, can seriously lower confidence and lead to deposit withdrawal.

Fiduciary risks also occur when the bank does not fulfil its fiduciary responsibility towards its depositors and shareholders. Some of the examples of fiduciary breach are the inability of banks to adequately screen and monitor projects and thereby neglecting evaluation, mismanagement of funds of current account holders and mismanagement in governing the business.

***Shari'ah* Compliance Risk**

Shari'ah compliance risk is connected with IFIs' adherence to the principles and values of the *Shari'ah*. This risk occurs when the banks follow non-standard practices for contracts in different jurisdictions and when they fail to adhere to the *Shari'ah* rules.

To avoid this risk, financial institutions must ensure that all their activities conform to the principles and values of Islam. This requires contracts and necessary supporting documentations including the legal papers, forms and processes to be *Shari'ah*-compliant. Other operational issues including treatment of interest based calculations, discounting, early and late payments and defaults must follow the *Shari'ah* rules.

Reputation Risk

Reputation risk arises from the failure of governance, business strategy and processes. The reputation of an IFI could be at stake if there is negative publicity about its business practices. If the perception of stakeholders becomes negative, it will cause a serious loss of trust and credibility to the IFIs. Non-compliance with the *Shari'ah* can be a reason for reputation risk which triggers the failure of the IFIs and causes systemic risk and instability.

The Risk Management Process

The process of risk management includes the following major steps:

1. Setting up of risk management policies.
2. Identification of risk types and exposures. It also involves measurement and estimation of risk exposures.
3. Assessment of effects of exposures and cost and benefits of instruments.
4. Development of risk management plan to mitigate the risks through risk control and risk financing mechanism.

5. Selection and implementation of risk management process by forming risk mitigation strategies.
6. Monitoring and reviewing of risk management process by evaluating the performance.

Fundamentals of Enterprise Risk Management (ERM)

Enterprise Risk management or ERM handles all risks that are significant with regards to the continuance and enrichment of the value of a firm. ERM addresses all of a firm's risks with an organised, integrated and coherent framework.

Let's now look at the purpose and goal of Enterprise Risk Management.

The Purpose of Enterprise Risk Management

The main purpose of ERM is to enhance a firm's economic value by reducing economic harms in it. Economic harms occur when future expenditures increase but future incomes drop, discount rates rise, existing wealth reduces.

The Goal of Enterprise Risk Management

The main goal of ERM is to maximise the value of an organisation by ensuring the alignment of the risk portfolio with the risk appetite of the organisation. The risk portfolio of an organisation can be modified by revising its operation, adjusting its capital structure and employing targeted financial instruments.

To achieve the main goal, ERM includes several sub-goals:

- Ensure that the firm's appetite for risk is aligned with its overall energy.
- Enhance risk response decisions by providing the means to manage multiple risks and tools to control the risks.
- Reduce operational risks by enhancing the firm's capability to identify potential events and ensure adequate responses.
- Identify and act on new business opportunities.
- Allow management to evaluate the firm's capital needs and allocate capital more effectively.

Enterprise Risk Management - Process

The ERM process stresses on critical areas such as goal setting, risk reporting and communications and goal achievement. These areas are then sub-divided into various sections such as environmental analysis, risk analysis, risk response and plan administration.

Environmental Analysis

Environmental analysis includes analysis of internal and external environment.

Internal Environment

Corporations rely on numerous techniques in conducting an internal analysis of risks that could materially affect their value. Some of the key sources of the internal environment are financial statements, income and cash flow statements, production operations inspections, questionnaires, brainstorming sessions and scenario planning.

The types of risks that can be identified from various sources within the internal environment include operational risks from sources such as earnings, assets, employees and legal liability and financial risks from sources such as currency or foreign exchange rates, interest rates, input price, output price and credit or counterparty risk.

External Environment

The opportunities and threats that are external to the organisation come under the category of strategic risk. These cannot be controlled by the firm because they arise from influences and trends associated with macroeconomic and external factors.

The responsibilities for managing strategic risks lie with highest levels of the organisation.

Risk Analysis

This includes risk qualification and mapping.

Risk qualification involves the assessment and analysis of quantitative risks, such as net present value or NPV, internal rate of return, capital asset pricing model and value at risk, and qualitative risks, such as scenario planning, brainstorming, decision tree analysis and CART, HAZOP and PERT.

Risk mapping involves the graphical positioning of events in terms of financial impact and probability.

Risk Response

Risk response includes risk financing, risk control techniques, risk related management standards and the international organisation for standardisation like the ISO 9000 series, the ISO 1400 series and Agenda 21.

Risk financing includes internal and external financing, contractual transfer, hedging and insurance. Risk control techniques include avoidance, loss prevention and loss reduction.

Plan Administration

Plan administration includes implementation, monitoring and review.

Plan monitoring and review includes centralised and decentralised risk management program and review.

Islamic Approach to Risk Taking Vs. Risk Avoidance

There are two sorts of incompatible human behavior. They are insurance and gambling. People buy insurance to avoid risks and gamble to take risks. Therefore, the two types of risks are risks associated with normal economic transactions and risks associated with zero-sum activities.

Islamic principles advocate the development and preservation of wealth. The approach towards hardship is the same. The primary factor of hardship is its usefulness and determining the value of the deed is secondary. The value would reflect its hardness, but only to the extent that it is useful.

Risk as such is not desirable, though it is inherent in all economic activities. The value of an economic decision is not determined based on the risks involved in it but according to the wealth it creates and value it adds. Risk is legitimate when it creates any value and is undesirable when it does not add any value.

Milestones in the Islamic Approach to Risk Reduction

The milestone concepts applied in the Islamic approach to risk reduction are hedging, tolerable risk, inevitability of risk, likelihood of failure, causality, investment versus gambling, choice under uncertainty, causal decision rule, statistical measure and derivatives.

Hedging

Hedging is used to neutralise and minimise risks and it naturally belongs to Islamic economic objectives. If the means of hedging involves assumptions and gambling activities, then it is illegal, even if the objective is to mitigate the risk. The *Sharī'ah* does not disapprove hedging since it brings some *Maslaha*. Achieving legitimate hedging without *Maisir* is a challenge to both Islamic finance and conventional finance.

Tolerable Risk

Muslim scholars believe that some risks can be tolerated under certain conditions, if they are inevitable, insignificant and unintentional.

The first condition implies that the same level of the concerned activity cannot be achieved without assuming the risk of loss or failure. The second condition implies that the risk can be insignificant and acceptable only if the likelihood of failure should be less than that of success. The third condition implies that the objective of an economic activity is to create a value and not the risk it necessitates. Therefore this risk cannot be intended to be a part of the activity.

Inevitability of Risk

Risks cannot be separated from any transactions which add value because separating risks from real transactions will create more risks and make the economy unstable.

From the *Sharī'ah's* perspective, exchange of pure liability for a given price is prohibited and it is consistent with the general trend of Islamic finance.

From the economic perspective, risk is necessary for economic progress and wealth creation. Therefore, risk may not be severed from economic activities.

Derivatives by construction thus appear to be in direct opposition to *Sharī'ah* principles because they separate risks from ownership and real activities.

Likelihood of Failure

The sources of *Fiqh* indicate that risk can be tolerable only if the likelihood of the failure is less than that of success. This is true, irrespective of the extent of the outcomes of the decision. This is in contrast to the expected utility rule in which a decision is based on the expected terms. For example, in a lottery, the probability of winning the prize is very small, while the probability of losing the ticket's price is significantly large. This is not acceptable from an Islamic perspective as it is almost certain that the loss will materialise. However,

the expected utility rule is based on the expected value and not on the state and leads to a different kind of behaviour known as deception and delusion or *Gharar*.

Causality

The condition of dominant likelihood of success is equivalent to the action that shall lead to or cause successful outcome. A cause need not lead to final outcome with certainty, but impacts the final outcome.

From an Islamic perspective, uncertainty requires the decision maker to think about proper causes to achieve desirable results and trust *Allah* (swt) to avoid possible failures. The former one is viewed as mandatory and the latter one as rational decision-making.

Taking an action that is more likely to lead to failure is a violation of Islamic teachings. This clearly shows that playing lottery is not acceptable as there are more chances of losing the ticket price. This holds good for any economic decision for which likelihood of failure dominates than that of success.

Investment Vs. Gambling

The main difference between investment and gambling is the confidence on success. For example, an entrepreneur may start a project because he is confident that he would succeed. On the other hand, a gambler knows in advance that there are more chances for him to lose than to win. According to Islamic principles, this difference is consistent with the concept of causality. An action that leads to failure more frequently than success is a cause of failure and not a cause of success.

Choice Under Uncertainty

According to the conventional theories of choice, uncertainty is viewed as a simple choice among lotteries. This is contradictory to the Islamic view as well as the real decision-making in business environments.

Based on the studies made by scholars, it is proved that risks are rarely taken by business managers. They always seek to adjust risks in a manner that enables them to confidently expect a successful outcome. According to a scholar, managers see themselves as risk taking ones, but they take risks only after modifying and working on the dangers so that they can be confident of the success.

Based on this context, risk taking is an endeavour where a manager can use his judgment, exert control and utilise skills. On the other hand, gambling is an inadequate metaphor of managerial risk taking.

These results point to the fundamental difference between risk associated with business activities and gambling, where likelihood of the failure is dominant.

A Causal Decision Rule

Amending the expected utility rule is possible by imposing a constraint on the likelihood of success.

Statistical Measure

Direct representation is obtained by invoking statistical measures of probability distribution. The expected utility rule is equal to the mean of the payoff distribution.

Mean is a measure of the central tendency of the distribution, which is defined as the sum of the values of the random variable divided by their respective probabilities.

Median is also an alternative measure of the distribution. Median is commonly defined as the point that divides the total distribution into two equal parts, each with probability of 50 per cent.

Derivatives

More than seven times out of 10, trading derivatives such as futures and options causes loss. If the likelihood of failure exceeds that of success, these instruments are considered as factors of loss, rather than gain.

Chapter Summary

You have completed the chapter, **Islamic Perspective on Risk Management**. The key points of this chapter are as follows:

- One of the main functions of financial institutions is to effectively manage risks that arise in financial transactions.
- Some of the financial risks that are associated with Islamic finance products are credit risk, liquidity risk, market risk, equity management risk and rate of return risk.
- Operational risk, a related type of governance risk occurs due to the failure of internal process, people and systems or external events.
- Strategic risks are the ones that cannot be directly controlled by a firm and they arise from macroeconomic and external influences and trends.
- Some of the types of strategic risks are displaced commercial risks or DCR, fiduciary risks, *Sharī'ah* compliance risks and reputation risks.
- Enterprise Risk Management or ERM deals with all the risks that are critical to the maintenance and enhancement of a firm's value.
- The Enterprise Risk Management process stresses on critical areas such as goal setting, risk reporting and communications and goal achievement.
- There are two sorts of incompatible human behavior. They are insurance and gambling.
- The milestone concepts applied in the Islamic approach to risk reduction are hedging, tolerable risk, inevitability of risk, likelihood of failure, causality, investment versus gambling, choice under uncertainty, causal decision rule, statistical measure and derivatives.

Course 6: Chapter 3

Chapter Introduction

Principles of Islamic Risk Management.

According to Islamic perspective, economic activities are not judged by their inherent risks, but by the value they add or the wealth they create. Islam views risk as an opportunity to make profits.

The Islamic approach to risk management involves understanding and controlling the causes of risks, but leaving the outcome to the Will of *Allâh* (swt).

The risk sharing approach to risk management is a central trait of Islamic banking or finance; it is included even in the statute of Medinah.

Debt based contracts such as *Murabahah*, *Salam*, *Istisna'a* and Islamic hire- purchase are examples of transfer of risks. Sharing of risk is an inherent feature of equity based contracts such as *Mudarabah* and *Musharakah*.

The risk management principles set by the Islamic Financial Services Board or IFSB are aligned to this approach. The principles guide, in accordance with the *Sharī'ah* rules, in managing each type of risk.

Risks in Islamic finance are plenty and are often interconnected. Risk profiles are different from but are not higher than that of conventional banking. Any risk management system will fail if the management is not disciplined and responsible.

In Islamic banking, six types of contracts such as *Musharakah*, *Mudarabah*, *Murabahah*, *Ijarah*, *Istisna'a* and *Salam* provide clear measures to mitigate economic risks.

On completing this chapter, you will be able to:

- Explain the Islamic approach to risk management and the related historical incidents.
- Describe the risk management framework adopted by Islamic banks.
- Explain how risks are managed in Islamic banks.
- Describe the failures caused if management at various levels is not disciplined and irresponsible.
- Explain the various types of hedging instruments used for effectively managing risks.
- Describe how risks are handled in the major Islamic modes of finance and
- Explain the integrated approach adopted for effective risk management.

Risk Management from an Islamic Viewpoint

According to Islam, economic activities are judged by the value they add or the wealth they create rather than by their implicit risks. Based on the literature on risk, three types of risks can be identified and they are essential risks, prohibited risks and permissible risks.

Al-Suweilem (2006) explained risk management by linking risk and causality. The scholar asserts that there is a need to distinguish between the causes of risks and their uncertain outcomes. He also points out that individuals have control over the causes of risks but not their final outcome. Therefore, the Islamic approach to risk management would be to control the causes of risks and leave the outcomes to the will of *Allah* (swt).

On the ethical aspect of risk management in Islam, the scholar asserts that deeds are judged by the intentions and means are treated in line with the ends. If an action leads to different outcomes, the value of the action should be based on the most probable outcome.

He concludes that an economic activity, in which the probability of gain exceeds the probability of loss, alone creates value.

The concepts applied in the Islamic approach to risk management include hedging, tolerable risk, inevitability of risk, likelihood of failure, causality and investment versus gambling.

Risk management concepts are covered in detail in Chapter 2, **Islamic Perspective on Risk Management**, of this course.

The literature on Islamic finance identifies sharing and transferring as the two ways of managing risks in finance. In conventional finance, risks are transferred through debt-based financing. In Islamic finance, risks are shared through *Musharakah* and *Mudarabah*. The literature also insisted that these two modes of risk sharing approach should be adopted by the IFIs.

In the history of Islam, there are many incidents that are closely related to risk management. They can be used as a benchmark in facing and managing risks. Some of the historical incidents that are related to risk management are the *Hijarah* of the Prophet (pbuh) from Makkah to Madinah, the Battle of *Badr* and the battle of *Khandaq*.

Based on the historical events, the implementation of risk management can be done through several steps such as risk avoiding, risk reduction, risk sharing and risk controlling.

Risk Management Framework

Islamic banks require a comprehensive framework of risk management, risk control and risk reporting to face the existing complex risks. High perception of risks in Islamic banks indicates a low degree of active risk management and absence of risk control through internal processes and controls.

An organisation-wide risk management framework is needed to cover measurement, reporting, management and control of all risks. Efficient risk management helps reduce the overall exposure to risk. Adequate resources should be devoted for risk identification and measurement and development of risk management techniques.

Risk management needs policy implementation, procedures, limits and also effective management information systems.

The set of principles to which Islamic banks must adhere to mitigate various kinds of risks include a good process for implementing all components of risk management, sufficient control system with the *Sharī'ah* inspired checks and balances, appropriate internal policies, regulatory policies and procedures, availability of qualitative and timely risk reports for regulatory authorities so they can provide support for identifying emerging problems and accurate and appropriately timed disclosure of information to Investment Account Holders or

IAH to assess the potential risks and protect their own interests when banks make decisions on funds invested with them.

Risk Management in Islamic Financial Institutions

Though the main elements of risk management include identifying, measuring, monitoring, and managing various risk exposures, these cannot be effectively implemented unless there is a broader process and system in place. The overall risk management process should be comprehensive embodying all departments or sections of the institution so as to create a risk management culture. It should be pointed out that the specific risk management process of individual financial institutions depends on the nature of activities and the size and sophistication of the institutions. Therefore, a comprehensive risk management system should encompass three important components.

Establishing an Effective Environment for Risk Management

This is the first stage and it deals with the overall objectives and strategy of a bank towards risk and its management policies. The board of directors is responsible for outlining the overall objectives, policies and strategies of risk management for any financial institution. The overall objectives should be communicated throughout the institution.

The board of directors should ensure that the management acts to identify, measure, monitor, and control risks. The board should periodically be informed through reports so they can review the status of the different risks to which the bank is exposed. Senior management is responsible for implementing these broad specifications. The management should establish policies and procedures that would be used by the institution to manage risk. These include maintaining a risk management review process, appropriate limits on risk taking, adequate systems of risk measurement, a comprehensive reporting system, and effective internal controls.

The procedures should include appropriate approval processes, limits and mechanisms designed to assure the bank's risk management objectives are achieved. Banks should clearly identify the individuals and/or committees responsible for risk management and define the line of authority and responsibility. Care should be taken that there is adequate separation of duties of risk measurement, monitoring and control functions.

Furthermore, clear rules and standards of participation should be provided regarding position limits, exposures to counterparties, credit and concentration. Investment guidelines and strategies should be followed to limit the risks involved in different activities. These guidelines should cover the structure of assets in terms of concentration and maturity, asset-liability mismatching, hedging, securitization, etc.

Maintaining an Appropriate Risk Measurement Process

Banks must have regular management information systems for measuring, monitoring, controlling and reporting different risk exposures. Some of the steps that need to be taken for risk measurement and monitoring purposes are establishing standards for categorisation and review of risks, consistent evaluation and rating of exposures. Bank can also use external sources to assess risk, by using either credit ratings, or supervisory risk assessment criterion like capital, assets, management, earnings, liquidity and sensitivity to risk or CAMELS.

Banks should do stress testing to see the effects on the portfolio resulting from different potential future changes. The areas a bank should examine are the effects of downturn in the industry or economy and market risk events on default rates and liquidity conditions of the bank. Stress testing should be designed to identify the conditions under which a bank's positions would be vulnerable and the possible responses to such situations.

Maintaining Adequate Internal Controls

Banks should have internal controls to ensure that all policies are adhered to. An effective system of internal control includes an adequate process to identify and evaluate different kinds of risks and sufficient information systems to support it. The system would also establish policies and procedures and their adherence are continually reviewed. These may include conducting periodic internal audits of different processes and producing regular independent reports and evaluations to identify areas of weakness. An important part of internal control is to ensure that the duties of those who measure, monitor and control risks are separated.

Finally, an incentive and accountability structure that is compatible with reduced risk taking on part of the employees is also an important element to reduce overall risk. A prerequisite of these incentive-based contracts is accurate reporting of the bank's exposures and internal control system. An efficient incentive compatible structure would limit individual positions to acceptable levels and encourage decision makers to manage risks in a manner that is consistent with the banks goals and objectives.

Causes for Failures within an Organisation

An organisation may fail due to various reasons such as application of impractical rules, confusion over authority and improper supervision. Therefore, the major causes that may lead to the failure of an organisation are control failures, management failures and regulatory failures.

Control Failures:

The causes for control failures include:

- A rubber stamp board of directors,
- Lack of correct attitude towards governance,
- Appointment of inexperienced board members,
- Easy manipulation of the board by a single institutional member,
- Lack of knowledge among board members about the financial and economic facts of the organisation,
- Lack of motivation among board members,
- Conflict of interest among board members with respect to their dual role as board members as well as clients of finance,
- Lack of experience and training among the bank staff and
- Functioning of the bank without proper systems of internal control.

Management Failures

The causes for management failures include:

- Lack of preparation for changing regulations,

- Lack of a Crisis Management Plan,
- Ad-hoc decision making during crisis and uncoordinated execution,
- Connected lending and investment concentration,
- Selection of executives from a previously failed bank,
- Allowing withdrawal from investment accounts,
- Failure in managing liquidity risk,
- Indulging in fraudulent practices such as using the name of fictitious parties for *Mudarabah* agency financing and
- Usage of funds for solving internal financial problems.

Regulatory Failures

The causes for regulatory failures include:

- Drastic application of rules,
- Lack of supervision,
- Lacuna in supervision of law,
- Unclear scope of deposit protection law and
- Confusion over identification of authority.

Use of Hedging Instruments for Risk Minimisation

Al-Suwailem (2002) has made an attempt to systematically address the Islamic financial industry's need for financial products that can be utilised for hedging against various financial risks. His approach not only addresses the future developmental challenges of the industry but also offers premises for developing a number of Islamic financial products for hedging and risk management.

He defines hedging as minimising exposure to risk and asserts that risk cannot be eliminated from economic activities. Therefore, financial intermediation is about managing risk, rather than avoiding risk. Thus, hedging effectively means managing risk, rather than eliminating it.

The challenge for Islamic financial institutions is to use hedging instruments that can achieve the benefits of risk distribution but do not lend themselves to gambling. Therefore, hedging instruments should be integrated with real, value-adding activities, and may not be neutral with respect to gambling.

The three possible strategies or approaches of hedging are economic hedging, contractual hedging and cooperative hedging.

Economic Hedging

This strategy originates from the decision maker and does not require explicit arrangements from the other agents to achieve desired hedging. The most obvious and oldest example is to diversify investments. Diversification is an essential hedging strategy that stands alone as well as complements other strategies.

However, it might appear that diversification hinders specialisation because specialisation requires focus on capital and labour. It is a tradeoff decision to the extent that the two strategies interfere with each other. Specialisation compensates for diversification by integrating output with complementary products to minimise the risk loss. In other words, integration at the output level may compensate for loss of diversification at the input level.

Investors specialising in a certain market can diversify the risks through holding a portfolio of diversified shares. Therefore, specialisation at the firm level can be compensated through diversification at the investors' level.

An important source of risk is the asymmetry between costs and revenues or liabilities and assets. This asymmetry exposes liquidity risks when the due payments on the liabilities side are mismatched with those on assets side. In addition, the firms are exposed to market risks when production is not aligned with demand, causing risk of loss to quick price changes and demand shifts.

Real business firms are continuously seeking technologies and strategies to align their revenues and costs. Some of the examples include 'direct-to-customer' sales strategy of Dell Computers, 'just-in-time' production strategy of Japan and efficient supply systems of Wal-Mart.

In contrast, conventional financial firms tend to have persistent misalignment between their assets and liabilities. Insurance companies too have imbalanced sheet structure with huge contingent liabilities and minor assets. Mismatching of assets and liabilities creates dangerous risks to the industry as well as the economy. Although the creation of central banks and deposit insurance reduced systemic consequences, it contributed to the persistence of the problem.

Derivatives play an important role in shifting some of the risks of misaligned balance sheets. As these risks are transferred to other players, firms find it more profitable to misalign the balance sheets, leading to additional use of derivatives.

The balance sheets of Islamic banks have greater alignment and symmetry and thus their structure is more stable. This shows that the alignment of balance sheets is the essential property of the Islamic system.

Natural Hedging

Natural hedging refers to the alignment of liabilities and assets to reduce the interest rate and currency risks. Balance sheet hedge is done by modifying the asset-liability volumes or their repricing characteristics to reduce the interest rate risk of a firm without purchasing derivative instruments such as interest rate swaps or futures. Companies use natural to avoid costs of derivatives and currency risks.

Dynamic Hedging

Dynamic hedging refers to trading strategies that can replicate the payoff of a given derivative using only the underlying security. Assuming complete markets and a frictionless world, an investor may be able to come across a portfolio that gives the same return as the derivative at maturity, without requiring any payment other than initial investment. This portfolio is called a replicating portfolio and its worth must be the same as that of the derivative. If not, there is an arbitrage opportunity or delta hedging, which replicates the return of a complex security through sophisticated trading of simple securities. This strategy is used for pricing derivatives and was pioneered for option pricing. However, perfect replication is impossible with incomplete markets and transaction costs.

Cooperative Hedging

Cooperative behaviour forms an essential framework for social interactions. Many important economic problems, especially risk sharing and distribution, can be effectively solved by cooperation rather than by for-profit arrangements. Reciprocity is vital for risk sharing and management, particularly when such behavioural concepts are lacking.

Cooperative hedging is an effective strategy for currency risks because the *Shari'ah* imposes strong restrictions on currency for-profit trading that makes conventional hedging nearly impossible. Accordingly, the most suitable risk management strategy for currency risks is through cooperative, not-for-profit techniques.

A cooperative fund can be established by Islamic institutions to distribute and share currency risks. The members who own this fund must have different risk profiles in order to efficiently diversify their risks. Each member will perform his operations normally, but would credit any gains or losses of currency exchange to his account with the fund. Surpluses are kept as reserves to cover future deficits. Initial deficits are covered from initial capital provided by members. To the extent that the members' risks are uncorrelated, gains and losses will be cancelled out and the members will be able to hedge their currency risks.

The detailed structure of the fund could be designed according to the members' preferences, but all kinds of risks of the fund are borne by the members. This achieves risk sharing in its purest form without the negative consequences of speculative trading.

Since cooperative structures are not-for-profit, there is no minimum for the number of members involved. Although a large number of participants would help diversify risks, the absence of such a condition makes it very flexible in cases where not many agents might be involved in. Bilateral risk sharing between the customer and the financier in ordinary Islamic finance can be designed using this feature.

Contractual Hedging

This strategy focuses on contractual, for-profit instruments. In Islamic finance, the risk management for-profit tools are inseparable from real activities. Therefore, a single instrument will provide finance, risk management and ownership together. In the next topic, we will explore more about some of the key Islamic instruments and how they can be modified to accommodate risk distribution.

Managing Risks in Islamic Modes of Finance

The main Islamic instruments that can be modified to accommodate risk distribution are *Mudarabah*, *Musharakah*, *Bai' Bithaman Ajil*, *Murabahah* and *Salam*.

Let's now look at how they can be used for managing risk.

Mudarabah

Mudarabah is the most ancient form of Islamic financing, where the capital owner provides capital to the agent for business projects. The profits are then shared based on predetermined ratios.

The three main types of risk involved in *Mudarabah* are risk of misreporting, capital risk or risk of loss and liquidity risk. Since *Mudarabah* represents a real investment, there is no significant liquidity risk occurs from *Shari'ah's* point of view.

Misreporting Risk

This is the most common risk related to *Mudarabah*, where the agent might announce losses, when in fact the project is making profits. By misreporting, the agent would keep the entire profit with himself. This is the reason why Islamic banks are not applying *Mudarabah* contract on the asset side of their balance sheets.

Although a *Mudarabah* is a sharing arrangement, Islamic banks can still carry out due diligence and carefully examine companies that request finance. The current practice of lending requires banks to extensively study the balance sheets and income statements of loan applicants in addition to management and ownership. Banks should not provide loans unless they are confident that the borrowers are able to pay back from their own generated revenues. Islamic banks should apply the same due diligence for applicants of *Mudarabah* since they are exposed to downside risk.

Capital Risk

In *Mudarabah*, investors face downside risk or risk of losing their capital. Due diligence and conditional payment can greatly minimise this risk and other alternatives may also be useful. One such alternative is to combine a deferred sale with partnership. In this alternative, the financier can hedge the downside while sharing in the upside.

Musharakah

Musharakah is another way for the downside risk to be hedged. In this contract, the investor or financier provides money to the company through *Musharakah* and becomes a passive shareholder in the company. All or part of an investor's share can be sold to a third party. The third party enjoys participation in the company without advance payment, and with relatively low markup cost. The most important thing is that the company does not bear any burden of debt at all and from its point of view, the investment is still a form of *Musharakah* and it allows all parties to gain.

Bai' Bithaman Ajil

In Islamic finance, *Bai' Bithaman Ajil* or deferred price sale is quite common. The main types of risk involved in deferred price sale are credit risk, liquidity risk and rate of return risk.

Credit Risk

Credit risk is very similar to conventional credit risk in terms of how it is treated. Banks can take collaterals and guarantees to protect their investment. In case of late or delayed payment, it wouldn't help much to add to the customer's outstanding debt by charging the customer.

Liquidity Risk

The *Sharī'ah* does not allow deferred price to be sold for cash since it is a monetary debt. The implication is that banks may be faced with liquidity risks for long term debts. There are at least two solutions to this problem. One is to exchange the debt for commodities instead of cash. The other is the combination of monetary debt and real assets into a single portfolio, where debts cannot exceed 50 percent, followed by securitisation of the portfolio.

Rate of Return Risk

After the conclusion of the sale, the deferred price cannot be increased since it is a debt. It means that a floating rate on a deferred sale is incompatible with the *Sharī'ah's* maxims. For long-term debt, this exposes both parties to the risk of changing rate of return or markup rate. This risk can be mitigated through cooperative solution.

Variability in rate of return can be reflected in the variability in duration of the contract through changing the instalment amount. If the market rate rises, the parties mutually agree to raise the instalment amount and thus shorten the duration. Conversely, if the market rate declines, the parties agree to reduce the instalment and extend the duration. Although this does not change the explicit return on the debt, it provides liquidity to the affected party, which can compensate for the lost return. This solution is cooperative since the adjustment has to be made with mutual consent at the time of change.

Murabahah

It is a cost-plus-sale contract where the financier purchases a product for an entrepreneur who does not have own capital for purchases.

Currency risk is a part of capital risk and diversification provides an indirect hedge against currency fluctuations. Transferring risk to the counterparty helps in hedging currency risk. If the counterparty is a conventional entity, it will get the assistance from conventional instruments.

Therefore currency risk can be hedged within a *Murabahah* transaction but not separately. This approach is consistent in risk management of real activities and is a part of value-adding transaction.

Salam

Salam has been known much before the time of the Prophet (peace be upon him). Financing and price discount is provided to the seller and the buyer respectively, if payment is advanced in exchange for a clearly specified quantity of a well defined good. The good's price value at maturity is the major problem in *Salam*. This price might be different from the expected price, and the gap might wipe out the benefits of the advanced payment.

There are many ways to address price fluctuations and one such solution is the value-based *Salam*. In this instrument, the buyer pays in advance the full price in exchange of a future good. In value-based *Salam*, the value is determined upfront rather than the quantity.

The buyer in this arrangement is able to hedge against price fluctuations of the future good. If the price at maturity declines, the quantity to be delivered will increase to compensate for the price reduction. Conversely, if the price rises, the quantity declines.

Rate of Return Risk

Value-based *Salam* may allow for capital protection, but it does not allow for market-linked, variable return. To allow for this option, a hybrid form of *Salam* can be adopted so that the deferred good consists of value-based component to minimise capital losses and quantity based component to allow for market return.

The classical form of *Salam* exposes investors to market return. However, the downside is hedged through the value-based form. The hybrid *Salam* manages both capital risk and rate of return risk, while the parallel *Salam* manages liquidity risk.

Integrated Approach to Risk Management

Let's now look at the integrated approaches adopted for effective risk management.

Payoff Structure of Contractual Hedging

Hedging instruments have a common payoff structure that allows for win-win outcomes and implies the possibility of zero-sum, win-lose outcomes. For example, the debtor will not be able to obtain the commodities at reasonable costs in value-based *Salam* and diversified *Murabahah*. Similarly, when deferred sale is combined with sharing, the debtor will fail to generate profits and thus becomes a loser.

The payoff structure combines risk transfer with mutual gain, while derivatives perform pure risk transfer without mutual gain. This shows that Islamic instruments provide the benefits of risk transfer without the costs of conflicts of interests and relative behaviour.

In addition, derivatives shift risk to those who are more willing to bear them, but not to those who are better able to manage them. In contrast, Islamic instruments shift risks to those who are more willing and able to bear them. Accordingly, risk is transferred to those who are able to contribute to value-creation and not to bear risks. This implies better ability to manage risks in a productive manner.

Specialised Institutions for Risk Management

Specialised Islamic institutions to manage risks are needed. For example, third party hedging, mutual hedging of currencies and intermediate *Murabahah* for currency hedging require such an entity. While Islamic insurance companies represent a step in that direction, the traditional insurance business falls short of comprehensive investment risk management.

There is no contradiction between these two because they would still manage risks in an integrated manner as found in third party hedging. Further, mutual hedging requires devoted institutions for managing such mutual arrangements. Thus, the need for specialised institutions arises from the general need for professional Islamic risk management, whether it is based on for-profit or not-for-profit techniques.

Chapter Summary

You have completed the chapter, **Principles of Islamic Risk Management**. The key points of this chapter are as follows:

- According to Islam, economic activities are judged by the value they add or the wealth they create rather than by their implicit risks. Based on this, a scholar has identified three types of risks such as essential risks, prohibited risks and permissible risks.
- The concepts applied in the Islamic approach to risk management include hedging, tolerable risk, inevitability of risk, likelihood of failure, causality and investment versus gambling.
- Islamic banks require a comprehensive risk management, risk reporting and risk control framework to face the existing complex risks.
- An effective risk management process should establish an effective risk management environment, maintain an appropriate risk measurement process and maintain adequate internal controls.
- The major causes for failure within an organisation are categorised into control failures, management failures and regulatory failures.
- The three possible strategies or approaches of hedging are economic hedging, cooperative hedging and contractual hedging.
- The main Islamic instruments that can be modified to accommodate risk distribution are *Mudarabah*, *Musharakah*, *Bai' Bithaman Ajil*, *Murabahah* and *Salam*.

Course 6: Chapter 4

Chapter Introduction

Legal Principles Underlying Islamic Insurance Products.

In Islam, the practice of insurance emerged from the practices of early Arab tribes in the form of the doctrine of *al-Aqila*, which had been approved by the Holy Prophet (peace be upon him). Later, insurance was gradually practiced by all and then made compulsory in a few cases.

In today's world, numerous companies selling *Sharī'ah*-based insurance are being established in many Islamic countries including Brunei, Indonesia, Malaysia, Iran, Saudi Arabia, Sudan, Luxembourg and Qatar.

Under the Islamic principles, the sources of insurance law can be categorised into general sources and specific sources. The general sources include the *Qur'ān*, the *Sunnah*, *Ijma'a*, *Qiyās*, *Ijtihad*, *Istihsan*, *Masalah al-Mursalah*, *'Urf* and *Fiqh*, while the specific sources include the general contract principles, the laws relating to liability, the principles of mutual cooperation, humanitarian law and *al-Mudharabah* and the concept of welfare. Therefore, all aspects of an insurance policy must comply with the *Sharī'ah* compliant principles to be deemed valid and enforceable under the Islamic law.

The most commonly used models of Islamic insurance are the *Mudharabah* model, the *Wakalah* model and the *Mudharabah-Wakalah* model. Some of the other models are the *Ta'awuni* model and the *Waqf* model. These models are covered in detail in chapter 7 of this course.

Even though insurance practice continues to grow around the world, Islamic scholars are still divided with regard to the validity of insurance policy. One group of scholars agrees with the concept and practice of all insurance, while another group of scholars agrees with the concept and practice of only general insurance, not life insurance. A third group of scholars completely opposes the idea and practice of insurance arguing that insurance is totally against the *Sharī'ah* principles.

Therefore, a new model for Islamic insurance practice has been proposed with numerous recommendations. The model stresses that all activities of insurance practice must be based on profit sharing principles because it justifies the principle of mutual welfare of the parties involved.

On completing this chapter, you will be able to:

- Describe the stages of Islamic insurance development ranging from the customary to the contemporary Islamic societies,
- Explain the proposed model for Islamic insurance contracts that operates based on the *Mudharabah* financing technique,
- Describe the limitations imposed by the *Sharī'ah* to purify transactions,
- Describe the fundamental characteristics based on which insurance contracts are held valid,

- Describe the rationale behind the practice of an insurance contract,
- Describe the generic sources of insurance law under Islamic principles and
- Describe the specific sources of insurance law under Islamic principles.

Six Stages of Islamic Insurance Development

The insurance practices and transactions had begun before the time of the Holy Prophet (peace be upon him) and had evolved slowly until the start of the 19th century. It is during this century that the meaning, concept and legality of an insurance contract were established by an Islamic scholar. Now, this is being followed by a number of insurance companies.

The evolution of Islamic insurance has been categorised into six stages. They are the practices of the doctrine of *al-Aqila*, practices of the Holy Prophet (peace be upon him), practices of companions, development in the 14th to 17th centuries, development in the 19th century and development in the 20th century.

Practices under *al-Aqila*

In the ancient period, there was a practice among tribes that, if any person from a particular tribe killed a person from another tribe, then the relatives of the killer, known as *Aqila*, had to pay compensation called blood money to the heirs of the victim. Researchers have considered that this was the origin of the concept of insurance.

In addition, recent research findings suggest that the word *Aqila* was used to address the paternal relatives of a killer because everybody in those tribes was ready to compensate the heirs of the victim. The contribution paid was a financial protection to the victim's heir and can, therefore, be considered as insurance straightaway.

Practices of the Holy Prophet (peace be upon him)

Insurance practices grew during the era of the Holy Prophet (peace be upon him). This could be revealed from the recognition of the ancient Arab's practices of *Aqila* and the relevant laws passed in the first constitution of Medina. The ancient Arab practice of *Aqila* had been accepted by the Holy Prophet (peace be upon him) himself. This has been justified in various verdicts or *Sunnah* of the Holy Prophet (peace be upon him).

The legislations passed in the first constitution had introduced a form of social insurance, which was practiced through *Dyat* or blood money, through *Fidya* or ransom and also by other forms of social insurance.

The blood money was obliged in mutual collaboration relying on the *Aqila* doctrine as stated in the constitution. The Holy Prophet (peace be upon him) also enacted a provision for rescuing the life of prisoners through the payment of ransom to be made by the relatives of the prisoners to the enemy. Such a contribution could be a form of social insurance. The first constitution also included other forms of social insurance which stated that the society is responsible for providing required help to the needy, ailing and poor.

Practices of the Companions

The doctrine of *Aqila* was applied in various forms during the time of the second Caliph of Islam, Sayedina Umar. During this period, the government promoted the practice of *Aqila*.

Sayedina Umar ordered for the establishment of *Diwan* of *Mujahideen* in different districts. The names recorded in the *Diwan* were expected to mutually cooperate with one another and sincerely contribute blood money for any murder from their own tribe.

Development in 14th to 17th Centuries

During this period, a *Sufi* Order of the *Kazeeruniyya* was found to be quite active in Malabar and China and it functioned as marine travel insurance. This order was related with *Abu Ishaq Ibrahim Ibn Shahariyahb's* tomb, whose blessings were considered protective against any danger while travelling by sea.

Development in the 19th Century

During this period, insurance practice was established as a legal entity. Its consideration as a legal institution guided many Muslims to understand the value of insurance practices and also encouraged them to participate in insurance business.

Thereafter, Muslims started involving themselves in insurance practices by purchasing it from foreign companies. In addition, they became insurers and began to establish insurance companies.

Development in the 20th Century

During this period, two *Fatwas* on insurance transactions were issued by an Islamic jurist, Muhammed Abduh. The first *Fatwa* stated that an insurance transaction is similar to the *al-Mudharabah* financing method. The other *Fatwa* legalised all transactions that are similar to donation or life insurance.

During this period, the growth of *Sharī'ah*-based insurance practices in both the Muslim and non-Muslim countries were satisfactory. However, many Islamic scholars are opposing the idea of insurance policy even today without giving any other option for the Muslim jurists.

Even though some elements of conventional insurance are not *Sharī'ah* compliant, it does not imply that the practice of insurance is totally unlawful. Therefore, Islamic scholars need greater creativity and should develop an alternative model of Islamic insurance ensuring exclusion of any prohibited elements.

Proposed Model for Islamic Insurance Contracts

Islamic insurance practice differs from conventional insurance practice. It means that Islamic insurance policies must be free from unlawful elements that are prohibited by the *Sharī'ah*.

Since the conventional insurance practice has some legal issues, a new model must be proposed with all the relevant changes.

The proposed model is different from the conventional insurance scheme.

Under this model, an Islamic insurance policy is a unilateral contract between the insured and the insurer where the insurer is obligated to provide compensation against any loss to the

subject matter of the policy, while the insured is not forced to pay premiums if he fails to pay premiums. However, it is a must for the insured to pay premiums for claiming the benefits. If the insured stops paying premiums, the premiums that have been paid till date should not be lost.

The Islamic insurance policy is based on the principle of mutual cooperation and solidarity as stated in verse two of the *Surah Al-Mâ'idah* of the Holy *Qur'ân*.

The Islamic insurance policy is based on the profit sharing technique of *al-Mudarabah*, though it does not contain *Ribâ*. In case of life insurance policy, the concept of determining one's life or death has been proved baseless.

Moreover, in this proposed model, the nominee is only a trustee, not an absolute beneficiary. He receives the benefits of the policy and distributes them among the legal heirs of the deceased in accordance with the principle of inheritance.

The model suggests that an agent working in an Islamic insurance company should share the profits arising from the transactions as salary and should not be paid out of the premiums.

The model also proposes that anybody who claims benefits must have an insurable interest on the subject matter. In addition, both the insured and the insurer must have legal capacity to enter into an insurance contract.

Furthermore, if the insured dies before the maturity of the policy, the beneficiary can claim the total paid-premiums, a share on the profits and dividends from the paid-premiums, in addition to an amount of donation from the company. But, if the insured is alive after the policy's maturity, he or she can claim all premiums that have been paid plus a share of profits and dividends.

In a general insurance policy, the premium payments will be given out as a donation and therefore, the insured cannot claim the paid-premiums if no loss occurs to the subject matter. But, if any loss occurs to the subject matter, the insurer is legally bound to compensate the insured as agreed in the contract.

Limitations Imposed by the *Shari'ah* on Insurance Contracts

Although an Islamic insurance policy has a flexible and wide scope, some limitations have been set by the *Shari'ah* for purifying the transactions.

Some of the limitations are:

- An insurance contract should be free from *Ribâ* in its investment activities because *Ribâ* generates selfishness, greediness, miserliness and wickedness at the individual level and is therefore forbidden in Islam.
- An insurance contract should be based on the principle of profit-sharing and not on the principle of fixed-rate interest.
- A nominee is not an absolute beneficiary but only a trustee who can receive the benefits and distributes them among legal heirs of the deceased in accordance with the principle of inheritance.
- An insurance contract can be enforceable only if it does not violate *Shari'ah* principles.
- Any person who is either below 18 years of age or insane will not be allowed to sign an insurance contract.

- If either of the parties of an insurance contract has an intention of gaining something, then the contract becomes unlawful.
- An insurance contract is enforceable only if it contains speculation of a risk on the subject matter.

Fundamental Characteristics of Insurance Contracts

Islamic Insurance contracts become valid and acceptable based on some fundamental characteristics. These characteristics are classified into sincerity or *Ikhlas*, absolute *Shari'ah* principles, moral attributes and elements.

Sincerity

All kinds of transactions in an Islamic insurance contract must be performed with purity and sincerity so as to attain the results desired by *Allâh (Subhanahu Wa Ta'ala)*. In addition, the parties must not aim at gaining something and should be bound by the transaction based on the principle of mutual cooperation, solidarity and brotherhood. Also, both the parties should have a faith in *Allâh (Subhanahu Wa Ta'ala)* for protection from any sudden loss because an insurer cannot guarantee protection from the ultimate loss of life.

Absolute *Shari'ah* Principles

Under the Islamic law, an insurance contract is not valid until it follows the principles of the *Shari'ah*. Therefore, the validity of an Islamic insurance contract rests with its adherence to the *Shari'ah* principles.

Moral Attributes

An Islamic insurance contract must follow certain moral attributes, such as the principle of good faith, honesty, disclosure and truthfulness. The parties involved in the contract should not aim at gaining anything but should adhere to the principle of mutual cooperation.

Elements of an Insurance Contract

It is recommended that an Islamic insurance contract should possess the following elements:

- The parties must possess legal capacity,
- Insurable interest should be available,
- The insurer should assure compensation for any loss to the insured,
- The payment of premiums by the insured,
- The presence of mutual consent by both parties,
- The presence of offer and acceptance with terms and conditions that are in compliance with the principle of good faith, honesty, disclosure and truthfulness and the principles of the *Shari'ah* and
- The presence of specification of period for the agreed policy.

Purpose of Insurance Contracts

An Islamic insurance policy is aimed at providing material assistance against unexpected damage or loss through mutual help and cooperation. Basic purposes of Islamic insurance policies include:

- It saves helpless people from unexpected material risks.
- It reduces poverty rate in the society and ensures a comfortable life for the poor. In today's world, anybody may become poor due to material loss or damage and it can be solved through an insurance policy.
- It ensures the development of mutual cooperation and brotherhood and cultivates solidarity among people.
- It plays a key role in producing a self-reliant society by protecting the insured from any loss or damage.
- It provides a fair commercial transaction to the society by following the *Sharī'ah* principles.
- It guarantees material safety for the dependents of the deceased, orphans and the poor in the society.
- It ensures security from unexpected risk and encourages people to involve in any lawful transaction without fearing loss or damage.

Generic Sources of Islamic Insurance Contracts

Since an Islamic insurance policy is valid only if it is based on the *Sharī'ah* principles, all sources of the policy should comply with the *Sharī'ah*. The sources of an Islamic insurance contract under the Islamic law can be divided into primary sources and secondary sources.

Secondary Sources

The secondary sources are strictly based on the primary sources of Islamic Insurance contracts.

Practices of the Companions

An insurance policy was developed on the basis of *al-Aqila* and it was practiced by the second caliph Sayedina Umar, who also directed the citizens to practice the same.

Ijtihad and Consensus Among Islamic Scholars

After a critical effort, a Hanafi lawyer Ibn Abidin discovered the idea, meaning and legal characteristics of an insurance policy. Over a period of time, most of the jurists and scholars accepted this concept. However, there are still some scholars who are yet to accept the idea and practice of insurance policies.

Analogical Sources

The practice of insurance contract can also be justified by analogical sources like *Qiyās*, *Istihsan* and *Istishab*, as long as these sources do not contradict the Holy *Qur'ān* and the *Sunnah*.

Masalah al-Mursalah

The principle of protecting people from unexpected risk is justified by the doctrine of *Masalah al-Mursalah*. Although insurance practice is based on this doctrine, it is valid only on conformity with the divine principles of the Holy *Qur'ān* and *Sunnah*.

'Urf

'*Urf* means practices or custom or usage of a community. It could also be used to justify matters that conform to the divine sanctions of *Allâh (Subhanahu Wa Ta'ala)*. In fact, insurance practice originated from *al-Aqila*, which was given approval by the Holy Prophet (peace be upon him) and it serves as a justification for its validity.

Fiqh

Validity of insurance contracts is justified by numerous provisions in the *Fiqh*. There are many books on *Fiqh* which discuss the relevant aspects of insurance practice either directly or indirectly and partially or wholly.

Literatures of Islamic Scholars

Distinguished Islamic scholars have written numerous books and articles supporting the validity of insurance contract and the important procedures and solutions for it. These scholars also provided ideas and solutions in their respective books. All this literature renders insurance practice valid in today's Islamic world.

Parliamentary Acts

Today, numerous *Shari'ah*-based insurance companies are operating in various countries such as Brunei, Malaysia, Qatar, Saudi Arabia and Sudan. These companies were incorporated based on the regulations of the *Shari'ah* boards and were approved by the parliaments of respective countries, directly or indirectly.

***Shari'ah* Supervisory Board**

The *Shari'ah* Supervisory Board supervises each *Shari'ah*-based insurance company. The supervisory board ensures that all activities of the insurance companies comply with the *Shari'ah*.

Precedents

Precedents are another possible source of insurance law and practice. Decisions made by Islamic scholars on several issues in an insurance contract could be helpful in governing the Islamic insurance practices. In addition to the Islamic scholars, the precedents set up by the courts could also be a valid source of insurance law and practice.

Decisions of Islamic Scholars

The unanimous decisions of Islamic scholars can also serve as a source of Islamic insurance contracts.

Specific Sources of Islamic Insurance Contracts

Based the generic sources, Islamic insurance contracts are also sourced from various principles such as the:

- Principles of contract or *Aqd*,
- Principles of liability,
- Principles of *Uberrimae Fidei*,

- Principles of *Mirath* and *Wasiyah*,
- Principles of *al-Wakala*,
- Principles of *Daman*,
- Principles of *al-Mudharabah* and *al-Musharakah*,
- Principles of rights and obligations,
- Principles of humanitarian law and
- Principles of mutual cooperation.

Principles of Contract or *Aqd*

An insurance contract unilaterally binds the parties through an offer and an acceptance that rely on the principles of the contract. An insurance contract normally requires the parties to the contract, legal capacities of the parties, subject matter, offer and acceptance, insurable interest and *Uberrime Fidei*. Most of these elements are available in a general contract.

Principles of Liability

In an insurance contract, the insurance company undertakes the responsibility to compensate the insured against any loss to the agreed subject matter and such a promise is considered an explicit liability. In addition, the rights and obligations of an insurance contract arise primarily from the law of contract and unlawful activities.

Principles of *Uberrimae Fidei*

If an insurance contract is to be enforced, both the parties should have good faith before and after signing the contract. Therefore, involvement of fraudulent acts, misrepresentation or false statement and non-disclosure of material facts could make the insurance contract invalid.

Principles of *Mirath* and *Wasiyah*

In a life insurance policy, the policyholder assigns a nominee who is not an absolute beneficiary of the policy. According to the *Fatwa* given by The National Council for Muslim Religious Affairs, Malaysia and the high court of Karachi, a nominee is just a trustee who would receive the benefits of a policy and distribute them among the legal heirs of the deceased in accordance with the principles of *Mirath* and *Wasiyah*.

Principles of *Al-Wakala* or Agencies

The appointments of an agent by the insurer and a broker by the insured have been practiced in order to make the transaction effective. The governing principles of brokers and agents are covered by the *Mejelle*.

Principle of *Daman* or Guarantee

In an insurance policy, the insurer guarantees material protection to the insured against any unexpected loss, damage or risk. The principle of *Daman* justifies such a guarantee.

Principles of *al-Mudharabah* and *al-Musharakah*

An Islamic insurance policy is based on the principle of *al-Mudharabah* financing. In this technique, one partner provides capital to the business while business skills are contributed by the other party. Accordingly, the profits are shared by both parties.

On the other hand, in an insurance policy, the insured pays regular premiums and the insurer invests those premiums in a business in which both parties share the profit in an agreed ratio. The insurer also guarantees to provide compensation to the insured against any unexpected loss to the subject matter. This is how an insurance policy is based on the *al-Mudharabah* financing technique.

An insurance policy is also based on *al-Musharakah* principle, where both parties are partners in the insurance policy.

Chapter 9 of this course, **Models of *Takaful*—Part 2**, explains various models of Islamic insurance such as the *Mudharabah* model, the *Wakalah* model, the *Mudharabah-Wakalah* model, the *Ta'awuni* model and the *Waqf* model.

Principles of Rights and Obligations

The principles of rights and obligations, on which insurances policies are based, arise from humanity and nature. For example, people, being afraid of unexpected loss or danger, provide material safety as a right for everyone. All such rights and obligations are justified by the Holy Prophet (peace be upon him).

Principles of Humanitarian Law

The main purpose of the Humanitarian Law is to encourage mutual understanding in the society to protect against unexpected loss or danger. Therefore it has been justified that an insurance policy should work in accordance with the Humanitarian Law.

Principles of Mutual Cooperation

In an insurance policy, both parties mutually agree to a lawful cooperation and the divine principles of mutual cooperation, solidarity and brotherhood justify such a mutual cooperation.

Chapter Summary

You have completed the chapter, **Legal Principles Underlying Islamic Insurance Products**. The key points of this chapter are as follows:

- The developmental milestones in Islamic insurance practices are classified into six stages.
- Islamic insurance policies must be free from unlawful elements that are prohibited by the *Shari'ah*.
- Despite the wider scope and flexibility of Islamic insurance policies, some limitations have been set by the *Shari'ah* for purifying the transactions.
- An Islamic insurance contract becomes valid based on certain fundamental characteristics such as sincerity or *Ikhlas*, absolute *Shari'ah* principles, moral attributes and elements of an insurance contract.

- An Islamic insurance policy is aimed at providing material assistance against unexpected damage or loss through the concept of mutual help and cooperation.
- Since an Islamic insurance policy is valid only if it is based on the *Sharī'ah* principles, all sources of the policy should comply with the *Sharī'ah*.
- The sources of an Islamic insurance contract under the Islamic law can be divided into primary sources and secondary sources.

