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RISK AND RISK MANAGEMENT OF TAKAFUL INDUSTRY

Nooraslinda Abdul Aris and Roszana Tapsir
Accounting Research Institute & Faculty of Accountancy
UiTM Shah Alam, 40450 Selangor, Malaysia
nooraslinda@salam.uitm.edu.my, rosza225@salam.uitm.edu.my

Mohammad Kamil bin Abu Talib
Jabatan Kemajuan Islam Malaysia
mohd_kamil@islam.gov.my

ABSTRACT

Islamic finance consists of Islamic banking, Islamic insurance and Islamic capital market. Being one of the major elements, takaful (Islamic insurance) does have a significant role in the industry. The concept of takaful is where a group of people participate in a scheme that enables them to share the burden of any misfortunes faced by any of the participants/policyholders, and where appropriate, compensation are paid using the funds contributed by the participants.

As far as takaful operators are concerned, the protection of human intellect, human property and human conscience directly related to the provision of takaful service. These are in line with the principles laid down by the maqasid al-shari'ah (higher objective of Islamic law) which can be classified into: (1) protection of human life; (2) protection of human intellect; (3) protection of human property; (4) protection of human honour; and (5) protection of human conscience (El-Sheikh, 1987).

The risk profile for Islamic finance can be categorised into generic risks and unique risks. Islamic finance with its unique characteristics give rise to a set of risk management challenges namely; (1) credit risk; (2) liquidity risk; (3) legal and fiduciary risk; (4) financial supervision and transparency; and (5) shari'ah supervision risk (Morisano 2009). Due to the rapid growth in Islamic finance, there is a need for a unique risk framework for Islamic institutions, particularly for takaful operators. Therefore, this paper looks at the risk' of takaful company. It also identifies the management of such risk by the takaful operator. The compliance of Shari'ah should have directs relationship with the management of risks since the unique risk for Islamic institution lies in the shari'ah supervision risk.

***Keywords**:* *Takaful, Shari'ah, Risk Management*

1.0 INTRODUCTION

Risk management is important in Islam and Takaful provides a way to manage risks in business according to Shari'ah principles. Takaful or Islamic insurance is an element of Islamic finance, which is considered as the second most important social institution in the Islamic community to counter poverty and deprivation (Patel, 2003). Over the past few years, takaful has enjoyed significant expansion with an estimated average annual growth rate of 25% versus 10.2% for the conventional insurance between year 2004 and 2007 (Essen, 2010). This growth is likely to remain in the coming years and should bring opportunities as the market continues to evolve and demand for takaful products increases. With 1.5 billion Muslim population around the globe, takaful is seen as a favourable long term market given the fact that Muslims are still characterized by low insurance penetration (Essen, 2010). This huge potential of takaful market gives rise to the issue of risk. Takaful operator as trustee appointed by the policyholder faces some challenges and risks. These risks must be managed properly as the impact may or may not be significant to the consumer.

Risk, as defined by Knechel (2002), is the likelihood that the outcome from a process will not meet expectations. Risk management on the other hand, is a process that identifies loss exposures faced by an organization and selects the most appropriate techniques for treating such exposures (Rejda, 2006). The literature on risk management has been focusing on assessing risk, and providing structure to manage risk (Liebenberg & Hoyt, 2003; Dowd, 1999). However, the nature these studies are for the finance industry in general. Essen (2010) and Karray (2010) agree that risk management has been an important issue for the takaful industry. Good risk management and sound corporate governance are said to reinforce the investors' and consumers' confidence in the sector thus enabling stimulation of growth.

In Southeast Asia, Malaysia continues to be the leader in takaful recorded has strong performance especially in the family takaful business (Karray, 2010). The Malaysian insurance industry is expected to continue its double digit growth rate, especially in the takaful family segment. Islamic Finance News (2010) reported that a growth of between 15% - 20% is expected for the Family Takaful business and 10% - 12% is expected under the General Takaful business in 2011.

While Islamic banking has gained its momentum in terms of dissemination of information, Takaful is seen to be lagging. Fewer discussions and research can be observed on the features, models, structures and regulation issues of Takaful (S. Saaty & Ahmad Ansari, 2009). Thus, there is a lack of understanding on the Takaful operation and risk, particularly in Malaysia. Hence this paper looks at the risk profile of the takaful industry. Next, the management of the risk is discussed to find a conclusion that the most prominent issue in takaful lies with the non-shari'ah compliance risk. Proper planning, control, implementation and monitoring must be put in place to ensure the society interest is well safeguard. The justice must exist for the benefit of the society as being commanded under the maqasid shari'ah.

2.0 TAKAFUL

Islamic insurance was first established in the early second century of the Islamic era. This was the time when Muslim Arabs started to expand their trade to India, Malay Archipelago and other countries in Asia. Due to the long journeys, they often had to incur huge losses because of mishaps and misfortunes or robberies along the way. Based on the Islamic principle of mutual help and cooperation in good and virtuous acts, they got together and mutually agreed to contribute to a fund before they started their long journey. The fund was used to compensate anyone in the group who suffered losses through any mishap. In fact the Europeans copied this, which was later known as marine insurance.

Takaful originates from the Islamic word kafalah, which means 'guaranteeing each other' or 'joint guarantee'. In principle, Takaful system is based on mutual co-operation, responsibility, assurance, protection and assistance between groups of participants. It is a form of mutual insurance (S. Saaty & Ahmad Ansari, 2009).

Section 2 of the Malaysian Takaful Act 1984 defines 'Takaful' as a scheme based on brotherhood, solidarity and mutual assistance, which provides for mutual financial aid and assistance to the participants in case of any need, whereby the participants mutually agree to contribute for that purpose. 'Takaful business' is a business of Takaful whose aims and operations do not involve any element which is not approved by Shari'ah.

Other researchers define Takaful as an Islamic system of mutual insurance built around the concept of donation also known as Tabarru'. Each participant contributes to a fund to cover expected claims, while also benefiting from a share of investment returns. There are some similarities between takaful and mutual or cooperative insurance. There must be cooperative principles in takaful, but there need not necessarily be Islamic principles in conventional mutual or cooperative insurance (Stagg-Macey, 2007).

An overwhelming majority of the Shari'ah scholars believe that the conventional insurance is unlawful. Takaful, the Islamic alternative to insurance is based on the concept of social solidarity, cooperation and mutual indemnification of losses among members. It is a pact among a group of persons who agree to jointly indemnify the loss or damage that may inflict upon any of them; out of the fund they donate collectively (Khan, 2005).

The central idea of a Takaful contract is that it is a financial transaction of a mutual co-operation between two parties to protect anyone of them from unexpected future material risk. In a Takaful transaction, the participant (insured) pays a particular amount of money known as the contribution (premium) to the Takaful operator (insurer) with a mutual agreement that the insurer is under a legal responsibility to provide the participant with a financial protection against unexpected loss, should it happen within the agreed period. However, in a case where the loss does not occur against the insured within the specified period, the insured is entitled for the whole amount of paid-premiums together with the share of profits made out of the cumulated paid-premiums based on the principle of Mudharabah (profit sharing) financing technique. In such a transaction, both the insurer and the insured are mutually helping each other for financial protection (Khan, 2003).

Takaful provides a form of indemnification in case of any tragedy in human life and loss to the business or property. Similar to insurance, the policyholders (recognized as Takaful partners) pay premium to indemnify each other. However, unlike most insurance, Takaful is akin to mutual insurance, where the profits earned from business conducted by the company with the subscribed funds is shared by the Takaful partners. The tabarru' concept governs the contribution part. Determination of such premium is based on modern tools, such as mortality tables and other actuarial requirements and standards. The investment or management of the funds is governed by Islamic financing instruments, particularly mudharabah. An important distinction of Takaful is that in regard to investment of funds, based on the presumed riba' or interest equivalence, it avoids any interest-based instruments. Thus, Takaful companies can engage or employ only Shari'ah-compliant instruments and models and the profits are distributed according to a pre-agreed ratio specified in the Takaful agreement. Likewise they share in any surplus or loss from the pool collectively, minimizing the chance of any over-pricing so common to insurance companies (Shari'ah Fortune, 2010).

All economic activities are permissible as long as it conforms to the Islamic tenets, i.e. they do not in any form contradict the Shari'ah principles and rules. According to Islam, all forms of transactions that contain any unlawful elements (riba', maisir and gharar) are void. However it is undisputable that risks and uncertainties, which we inherited today, may lead to severe losses. Hence the demand of maqasid shari'ah that encompasses the essence of peace and economic well being imposes an obligation on all Muslim to do their utmost best and seek cover against danger (Abdul Aris & Othman, 2011).

A major ethical component of any Islamic financial transaction is to provide justice, honest and fairness and to ensure all parties their rights and dues. In a way, Islamic finance is developed as a social discipline in response to this environment. Although Islamic finance does perform mostly the same functions as the conventional, there is always a distinct unique difference i.e. the principles applied. Ahmad, (2000), Mirakhor (2000) and Warde (2000) express that Islamic business is always characterised by ethical norms and social commitments, grounded on ethical and moral framework of the Shari'ah. Asyraf (2006) also states that these Shari'ah injunctions interweave Islamic financial transactions with genuine concern for ethically and socially responsible activities and at the same time prohibiting involvement in illegal activities or those which are detrimental to social and environmental well-being. Khalifa (2003) also describes Islamic economics as Godly, ethical, humanly, and moderate and balanced. Therefore, all forms of exploitation are prohibited in Islamic financial system and should be strengthen with the ethical rules of Shari'ah (Abu-Tapanjeh, 2009). Thus, the primary feature of Islamic economy is to give just, honest, fair and balanced society as envisioned in the Islamic ethical values and rules.

3.0 RISK

Risk is the probability that a chosen action will lead to a loss or undesirable outcome. Knechel (2002) defines risk as the likelihood that the outcome from a process will not meet expectations. Risk is also defined as uncertain future events which could influence the achievement of the business's objectives, including strategic, operational, financial and compliance objectives. Potential losses themselves may also be called 'risks'. Any human endeavour and business carries some risk, but some are much riskier than others. In a nutshell, risk denotes losses.

An important thread leading to risk analysis is traced to an early religious idea concerning the probability of an afterlife. Although it seems to be surprising, the salience and seriousness of the risk involved especially for the believers have been discussed by many researchers (Covello & Mumpower, 1985). It is believed that a good intention and act will lead to a good life now and hereafter. This is in accordance to the Islamic teaching and its maqasid shari'ah whereby every human is required to protect themselves.

Traditionally, the concept of risk has been associated with uncertainty of events in future. The higher the uncertainty of events, the higher is the risk. In insurance, risk is the amount of loss associated with property or life. Risk to property can be a loss or damage to car, building, house, etc. Risk to life can be described as poor health, premature death, bodily injuries as a result of accident etc (Rejda, 2006). "Risk is the chance of happening of something that will have an impact upon our objectives. It is measured in terms of likelihood and consequences" (GOWA, 2002).

Al-Jasser, the governor of the Saudi Arabian Monetary Agency (SAMA) and IFSB Chairman commented that 'Risk has no religion' in a conference held in Kuala Lumpur on financial stability in 2009. Risk, for a financial institution, is indeed simply risk, even for an Islamic Financial Institution (IFI). Given that in most countries, a dual financial systems exist (where conventional and Islamic walk on parallel basis), the IFIs will need to consider an additional layer of risk i.e. the shari'ah non-compliance risk (Editor IFN, 2009). Notwithstanding that, the IFIs also have to consider their moral obligations to both the shari'ah and a trusting market, whilst using solid financial frameworks.

Risks in Islamic finance are categorised into two themes, namely the generic risks and the unique risks. The generic risks are credit risk, market risk, liquidity risk and operational risk. While the unique risks include shari'ah non-compliance risk, rate of return risk, displaced commercial risk and equity investment risk. Among these unique risks, shari'ah non-compliance risk is said to be the most significant to the Islamic finance including takaful industry.

Shari'ah non-compliance risk is the risk arising from failure to comply with shari'ah rules and principles as determined by the shari'ah regulatory council. In Malaysia, the highest authority of shari'ah lies with the national shari'ah advisory council of the Central Bank of Malaysia (Bank Negara Malaysia or BNM) and the Security Commission. Shari'ah non-compliance risk is considered paramount as it is the distinguishing factor between the Islamic and conventional systems.

Islamic Financial Service Board (IFSB) classifies risk into six categories namely operational risk, credit risk, equity investment risk, market risk, liquidity risk and rate of return risk. Operational risk is defined as risk of losses resulting from inadequate of failed internal process, people and system or from external events, which include legal risk and shari'ah compliance risk, but exclude strategic and operational risk (IFSB, 2004). The shari'ah compliance risk cuts across the six categories of risk and is considered as part of the operational risk. Therefore, shari'ah compliance is an important feature in an Islamic financial institution.

3.1 Shari'ah Compliance

Shari'ah compliance as written by Abdul Majid (2009) is any transaction and/or process which does not contradict Islamic principles. Shari'ah compliance is a continuous end to end process and covers all aspects in an IFI's operations. The scope of shari'ah compliance includes the takaful model (mudharabah, wakalah or hybrid), takaful products, investments, contract wordings, marketing collateral, surplus sharing and fee structures (Ahmed, 2010). It is the fundamental basis for having an insurance system that meets the religious requirements of Muslim in line with their 'aqidah (faith). Hence, IFIs need to strike a balance by implementing equally effective measures that comply with both shari'ah requirements and sound financial practice. Shari'ah risk should be the forefront for the IFI including takaful companies. As the society understanding on shari'ah is generally low, they tend to rely heavily and put their trust on the takaful's shari'ah supervisory board decision on products and operation.

One of the aspects under shari'ah compliance is to ensure acceptance, validity and enforceability of contract according to the shari'ah law. Breeching any shari'ah element in a contract will result in severe implications, both financial and non-financial. From financial perspective, the contract may be invalid and result in obtaining illegal profit from such transaction. Non-financial impacts include impediment from ALLAH's barakah (blessing), against the command of ALLAH, contravening the provision of legislations (Takaful Act 1984 and Islamic Banking Act 1983) and jeopardising the reputation of the IFI. Thus, the concpet of ibadah as promoted in islam will not materialise. This shows that shari'ah non-compliance is a real risk which may lead to serious losses for the takaful operator.

Shari'ah non-compliance in investments may be 'purified' through charity (sadaqah, zakat) which results in income loss for the shareholders. Permissible investments avenue may turn into impermissible which require the operator to discontinue the investment by way of donation to the charity. Therefore, screening criteria to determine permissible investment avenues increase time and cost in short term but improves corporate credibility in longer time.

Generally, Islamic financial services market is built on a societal foundation or religious principles that may help the institutions introduce products designed and priced based on the principle of societal (member) equality (Kwon, 2007). Any approach to Islamic insurance must acknowledge the importance of economic growth as well as social justice. Takaful is said to be based on the principles laid down by Islamic teachings, which is classified into: protection of human life; protection of human intellect; protection of human property; protection of human honour; and protection of human conscience (El-Sheikh, 1987).

In Malaysia, the IFIs are guided by their internal Shari'ah Supervisory Board which are established to advise and ensure their products comply and adhere to the Shari'ah principles. This is a requirement by BNM to all IFIs including takaful companies. To oversee the institutions compliance (products, services and operations), BNM also has a Shari'ah Advisory Coucil (SAC). BNM is continuously enhancing the Shari'ah framework to be in line with the developments in the takaful industry. This is crucial to ensure uniformity of Shari'ah interpretations in its effort to strengthen the regulatory framework of the Islamic finance industry. The strong Shari'ah framework enhances consumer confidence and gives greater flexibility for takaful operators to be innovative within the boundary of Shari'ah (BNM, 2005).

The Shari'ah classifies all matters into either halal (those permitted) or haram (those prohibited). For example, it permits takaful (shared responsibility) and strongly encourages such practice among Muslims. It also permits zakat, which obliges the rich to help the destitute and weaker members of society. In contrast, the Shari'ah prohibits exploitation and risky investments because Muslim jurists generally view that these activities are gharar (contracts in which results are unknown, hidden or speculative in nature) (Ismail, 1997) and the market must be a place for exchange of products and services where all parties in each contract explicitly know the prices. Riba (charging predetermined interest) is also forbidden in Islam regardless of the purpose for which such a loan is made and the rates at which interest is charged. As a result, Islamic financial transactions are, at least in principle; interest free (Ahmad, 1967).

Islamic transactions have more levels of authorization compared to conventional insurance. The transaction between takaful operator and the participant for example uses the contract of either mudharabah (profit-sharing) or wakalah (agent). The conventional insurance is based on selling of policy. The transactions performed must comply with the conditions outlined by the Shari'ah. Abd Rahman (2010) reports that there are issues that need careful inspection by the takaful operators to ensure that the takaful products and operations conform to the shari'ah principles. Among the inspection include the shari'ah concept applied to the product and getting approval from the company's SAB and also the SAC of BNM. After the approval, a training program and briefing on the concepts and implementation of the product will be conducted for all officials in charge directly with the marketing and consumer to ensure right information are being disseminated. This process, although seems to be simple but there exist significant problems as most of the employees are ex-conventional staff. They are faced with the problem of understanding the products and thus, deliver inaccurate information to the takaful customers when in fact, all products, contracts and transactions have been examined carefully and approved by the Shari'ah advisor. This is an operational risk to the takaful operators.

4.0 RISK MANAGEMENT

Risks will always exist despite firms' efforts to manage risks effectively and put precautionary measures in place. Identifying risks is easier than calculating the magnitude of losses that firms suffer. Management, from an Islamic perspective includes treating human life as an organic whole, where there is no demarcation between matters, secular, and religious. All human activities are ibadah provided they follow the guidance and the principles of shari'ah (Kazmi, 2004). Men have choices, freewill and freedom of action and are therefore, responsible and accountable for their actions. As Muslim managers in business organizations, any actions and decisions made are actually ibadah if they fulfil and comply with the principles of shari'ah. Thus, it is their responsibility to provide insurance service to Muslims in particular. In doing so, they are fulfilling their obligations as Muslims.

According to New Zealand standard of Risk Management (2004), "It is the culture, processes and structures that are directed towards the effective management of potential opportunities and adverse effects". In fact, risk management is an ongoing process that encompasses all aspects of our life.

Risk management systems and procedures are not new (Liu et al., 2007). Managing risk involves creating awareness of uncertainty, qualifying the risks, managing the controllable risks, and minimizing the impact of uncontrollable risks by risk allocation/apportionment (Liu et al., 2003). Ineffective risk management is often caused by lack of formalized risk management procedures, including risk identification, analysis and control (Tah and Carr, 2001); lack of continuity of risk management in the different stages in the project life cycle; poor integration between risk management and other key processes; and a lack of interaction among different parties (Liu et al., 2007).

Key areas of risk management in takaful are shari'ah compliance, investment management and human resources. The shari'ah compliance as mentioned earlier is a continuous process and the takaful operator must at all times ensure its adherence. Non-compliant to shari'ah will result in serious losses not only to the customer but also to the shareholders, company and the industry as a whole.

Risk profiles and risk preferences are different among organisations. The introduction of risk management committee at the board level emphasises the importance of managing risk (Mendoza, Supangco, & Tolosa, 2005). There is a need for a separate board to review risk assessment and management although the CEO initiates and implements corporate strategies which include risk.

Risk management in takaful industry is a process to identify potential losses of an operator and to select the most appropriate techniques for treating such potential losses. To ensure the effectiveness of overall management, takaful operators are required to observe the Guidelines on Directorship for Takaful Operators, which govern the appointment of directors and chief executives and the setting up of board committees, including risk management committee. In addition, takaful operators are also required to observe prudential limits and conditions imposed on the outsourcing of the management of takaful funds so as to ensure that the funds are properly managed within the accepted risk management framework (BNM, 2005). Although Takaful operators has a Chief Risk Officer (CRO) in the organisation to foresee the overall risk including the operational risk, it is also vital for them to assess and ensure its compliance with Shari'ah requirements. One of the major roles of CRO is to integrate procedures to report on major risks, ensure the most significant risk compliance and risk identification (Yazid, Wan Daud, & Hussin, 2008).

BNM places great importance in ensuring that the overall Islamic financial system operates in accordance with Shari'ah principles. This is to be achieved through the two-tier Shari'ah governance infrastructure comprising of two vital components, which are a centralised Shari'ah advisory body at the Bank and an internal Shari'ah Committee formed in each respective Islamic financial institution (IFI). The shari'ah governance framework introduced by BNM is designed to ensure the IFIs structure, processes and arrangement of their operations and business activities are in accordance with Shari'ah. It also acts as a guide to the board, Shari'ah Committee and management of the IFI in discharging its duties in matters relating to Shari'ah as well outlines the functions relating to Shari'ah review, Shari'ah audit, Shari'ah risk management and Shari'ah research (BNM, 2010). Shari'ah risk management is a function to systematically monitor and control the identification and assessment of Shari'ah risk to avoid any Shari'ah non-compliances. The systematic approach of managing Shari'ah risk will enable the IFI to continue its operations and activities effectively without exposing the IFI to unacceptable level of risk.

4.1 Managing the Risk of Takaful Operator

The objectives of risk management in takaful, among others are (1) to protect the safety of the takaful fund; (2) to ensure the fund is able to pay claims and obligations; (3) to achieve a required rate of return on investment if possible; (4) ability to withstand an adverse conditions; and (5) to ensure continuity as a going concern.

Most of the takaful operators classified their risks into three headings namely the takaful (business) risk, financial risk and operational risk. Identifying and classifying the risk in takaful business is important as it will enable them to manage the risk more effectively.

Approaches to risk management may include having a common language in terms of concepts, definition and classification; adopt a wide disciplined approach; creating and instil a strong risk governance; focused on aspects that is quantifiable and seek for continuous improvement. In this sense, the industry is able to share the best practice among the takaful operators. Adopting the appropriate approach will make risk management more relevant, practical and acceptable. The important techniques of risk management adopted by the takaful operator are self assessment risk, asset liability management (ALM), solvency capital, retakaful or risk transfer program, key risk indicators (KRI) warning the business on possibility of risk and any losses and business continuity management. The recent trend for the takaful operator is to adopt the Enterprise Risk Management (ERM). There is a growing demand from the shareholders and senior management to implement ERM in their organisation as this means formalising the essential connection between the business operations and its overall risk management program (Shimpi & Lowe, 2006). The initial stage of ERM is mostly about compliance and corporate governance and this may include the shari'ah compliance.

Enterprise risk management (ERM) has emerged as a new paradigm for managing the portfolio of risks that face the organisations and policy makers continue to focus on mechanisms to improve corporate governance and risk management. ERM is the process of planning, organizing, leading, and controlling the activities of an organization in order to minimize the effects of risk on an organization's capital and earnings. ERM expands the process to include not just risks associated with accidental losses, but also financial, strategic, operational, and other risks. ERM could be considered as a systematic approach for managing risk (Mikes, 2005). If the risk were to be managed effectively, companies may possibly achieve their corporate objectives and eventually create value for their stakeholders. Despite these developments, there is little research on factors associated with the implementation of ERM. Research is needed to provide insights as to why some organizations are responding to changing risk profiles by embracing ERM and others are not (Beasly, Clune, & Hermanson, 2005). It is not known whether ERM can mitigate the risks associated with the takaful industry. As discussed, the prominent issue in takaful is the shari'ah non-compliance risk. If the takaful categorised shari'ah compliance as part of its operational risk, then ERM may be a valid and strategic tool in managing the risk of takaful operators. Whatever classification given to the shari'ah compliance risk, the issue is pertinent in the overall takaful operations.

5.0 CONCLUSION

In line with shari'ah requirements and the concept of takaful, risk management practice and management of a takaful operator should be better off than a conventional insurance operator. Protection that is in accordance with maqasid shari'ah needs to be integrated into the Islamic finance activities. Takaful operators need to be proactive in managing their risks as part of good governance and best practice code. Self regulatory is needed rather than depending on regulatory requirements. As risk is an on-going process, continuous development of knowledge is required in order to understand and manage the risks effectively. Irrespective of the business model adopted by the takaful operators (mudharabah or wakalah or hybrid), the risk management will be the same since the basis is shari'ah.

Although it is arguable that the Islamic financial system (including takaful) has significant impact on the economics for the past three decades, a small impact is better than nothing (Abd Rahman, 2010) since we are living under constraints (dual economic systems). It is at least a sign of change to ensure that we are working towards changing the mind of the society in general and Muslims in particular.

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