

## RISK MANAGEMENT AND TAKAFUL

Previously we discussed three Islamic worldviews of financial planning, namely:

1. Financial planning is Worship (*Ibadah*);
2. Wealth is a Trust (*Amanah*) from Allah that must be administered properly;
3. Wealth is a major means to achieve *al-Falah*.

And, we said that the four major Islamic financial planning components are derived from these worldviews.

In this article we will look at the first component, that is, Risk Management and Takaful and how it relates to financial planning.

To start, we shall bring *Wealth Management* into our discussion and will treat *Wealth Management* and *Financial Planning* as being the same for simplicity sake. Wealth management has been described as an advanced type of financial planning but the concept – as oppose to the practices – is the same.

### **Risk Management and Takaful relates to issues in wealth protection**

Conventionally, wealth protection is carried out through the purchase of an insurance policy. In Islamic wealth management and financial planning, wealth protection is done through participating in a Takaful scheme.

Without doubt the effect of an insurance policy and a takaful scheme to the client should the insured peril happen is the same; that is, the client or beneficiary will receive compensation for the sum assured. However, there are fundamental differences between insurance and takaful, both, in concept and practices.

We shall discuss the differences but let us discuss Risk management first for better understanding of *Wealth protection*.

People relate to risk as a matter that is unfavourable. In finance, risk is often defined as uncertainty of returns. However, this is only true when we talk about investment risk and wealth accumulation. Since this narrow understanding is quite prevalent, let us define risk properly to understand Risk management, especially in the broader context of financial planning.

Risk is the possibility of suffering harm or loss. Risk can be assessed qualitatively or quantitatively depending on specific applications and situational contexts. Examples of commonly used term to described risk include Credit risk, Forex risk, Political risk, HIV risk, etc. However, since our subject is wealth protection, we will restrict our discussion to risks in relation to assets used in the production of an income and the earnings capacity of a person.

### **Risk can be divided into two categories: Pure and Speculative**

Pure risk is a category of risk in which loss is the only possible outcome and there is no favourable result. In Speculative risk, there are three outcomes – the possibilities of loss, gain and breakeven. Investment risk belongs to this speculative category. Examples of pure risk are the peril of fire or flood. Loss of service of a key employee

or the breadwinner of a family due to death – either through illness or accidental – is also of pure risk. In pure risk, the extent of the possible loss is unknown.

### **Risk management and takaful planning deals with Pure risk**

The main idea is protection and this must be well understood first, before we bring the subject of investment returns into our discussion. In the current practices of the insurance and takaful industry, a lot of emphasis is given to hybrid products in the form of investment-linked insurance or takaful products. In hybrid products, the risk management and investment aspects have been bundled. Terms like *capital protected*, *capital guaranteed* or *guaranteed returns* are used freely but the exact meaning largely depends on the contract being signed by consumer. Without proper understanding of risk management, it is quite difficult for the consumer to make an informed decision about the hybrid financial product. It is very important for consumers – and sales personnel also – to understand what the products are for and are NOT for.

To manage risks properly, these basic steps are recommended in the risk management process:

1. establish context and define parameters;
2. assess the risks – by identification, analysis and evaluation;
3. treat the risks – by either transfer, sharing, reduction or avoidance;
4. monitor and review (and goes back to the first step).

In the above process, it is in the third step that an insurance or takaful solution becomes relevant. In wealth management and financial planning, the risk management process is quite simple for the majority income earners but it gets complicated for businessmen, top management of large companies and top government officials (commonly referred to as the High Net Worth group).

Let us now discuss the Islamic worldview of risk management.

### **Pure risk is of Allah and Islam encourages risk management**

When loss is caused by a hazard, most people accept it as fate. Hazard by definition is unavoidable risk. Death by accident is a hazard that we face everyday, as we wake up and do our chores. The possibility increases when we are on the road going to the office. It increases even more when driving during festive seasons. So, is there an Islamic worldview on managing risk? The answer is yes, of course.

Consider the following *Hadith* related by Tirmidhi: One day Prophet Muhammad, peace and blessings be upon him, noticed a Bedouin (desert-dwelling Arab) leaving his camel without tying the animal. He asked the Bedouin, 'Why don't you tie down your camel?' The Bedouin answered, 'I put my trust in Allâh.' The Prophet then said, 'Tie your camel first, then put your trust in Allâh'.

To lose an untied camel is pure risk. The camel may or may not be there when the Bedouin comes back. Tying down the camel is risk reduction. A tied camel can still be missing if the animal is stolen but that is another peril altogether. The point is: Islam encourages risk management. The urging of the Prophet on the Bedouin to tie down the camel clearly demonstrates the Islamic position on risk management.

Now that we understand the basics of risk management, let us discuss the core concept in Takaful.

**The core of Takaful is the *Tabarru'* concept**

Allah enjoins the Muslims to co-operate in doing good things. In the Quran, He says: *Help you one another in righteousness (al-birr) and piety (at-taqwa), but help you not one another in sin and rancour. And fear Allah. Verily, Allah is strict in punishment (5:2).*

The takaful industry is an example of such co-operation; and truly, the *tabarru'* concept is its core.

Bank Negara Malaysia explains: “*Tabarru'* is the agreement by a participant to relinquish as donation, a certain proportion of the takaful contribution that he agrees or undertakes to pay, thus enabling him to fulfil his obligation of mutual help and joint guarantee should any of his fellow participants suffer a defined loss. The concept of *tabarru'* eliminates the element of uncertainty in the takaful contract. The sharing of profit or surplus that may emerge from the operations of takaful is made only after the obligation of assisting the fellow participants has been fulfilled. Thus, the operation of takaful may be envisaged as a profit sharing business venture between the takaful operator and the individual members of a group of participants.”

The takaful operator acts as a management company of the takaful schemes, similar to the collective investment scheme structure. The difference between the two is that, apart from management fees, the takaful operator also earns through pre-agreed profit sharing arrangement.

In insurance, there is no concept or practice of *tabarru'*. This may explain why some analysts looked upon insurance as risk transfer and takaful as risk sharing solutions in the risk management process.

Takaful originates from the Arabic word *Kafalah* that means guarantee or surety. Thus, the takaful industry is all about co-operating to guarantee each other against a defined loss; and not about transferring risk to an insurer for the price of a premium.

We have now come to the end of our discussion. To conclude, it is hoped that the brief explanation provided has added to our reader's understanding of risk management and takaful, and its role in Islamic financial planning.

We shall discuss Islamic Investment – another Islamic financial planning component – in the next article.