Islamic Financial Teachings Especially Financial Risk Management Through Takaful

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Understanding Islamic Finance

Islamic finance is a system based on Shariah principles, including the prohibition of interest (riba), uncertainty (gharar), and speculation (maysir). It emphasizes ethical and socially responsible financial practices, promoting fairness and justice in economic transactions.

Financial Teachings - Holy Quran

أَهُمْ يَقْسِمُونَ رَحْمَتَ رَبِّكَ ۚ نَحْنُ قَسَمْنَا بَيْنَهُم مَّعِيشَتَهُمْ فِي الْحَيَاةِ الدُّنْيَا ۚ وَرَفَعْنَا بَعْضَهُمْ فَوْقَ بَعْضٍ
دَرَجَاتٍ لِّيَتَّخِذَ بَعْضُهُم بَعْضًا سُخْرِيًّا ۗ وَرَحْمَتُ رَبِّكَ خَيْرٌ مِّمَّا يَجْمَعُونَ

القران الكريم - سورة الزخرف ٣٢

من يتق الله يجعل له مخرجا و يرزقه من حيث لا يحتسب

القران الكريم - سورة سورة الطلاق ٢،٣

Financial Teachings - Hadees

امام صادق علیہ السلام :الکاد علی عیاله کالمجاهد فی سبیل الله - وسائل الشیعۃ، ج 17، ص 66

امام صادق علیہ السلام :ان الله عز وجل یبغض کثرۃ النوم و کثرۃ الفراغ - الکافی، ج 5، ص 84

امام صادق علیہ السلام :لا ادعولک، اطلب کما امرک الله عز وجل - الکافی، ج 5، ص 78

امام صادق علیہ السلام :اتخذ عقدۃ او ضیعة فان الرجل اذا نزلت به النازلة او المصیبة فذکر ان وراء ظهره ما یقیم عیاله کان اسخی لنفسه -الکافی، ج 5، ص 92

امام صادق علیہ السلام :رجل جالس فی بیته یقول اللهم ارزقنی فیقال له الم آمرک بالطلب -اصول کافی، باب من لا تستجاب دعوتہ، حدیث 2

RISK

Risks are ***uncertain future events*** that could influence the achievement of the Bank's objectives, including strategic, operational, financial and compliance objectives.

Uncertain future events could be:

- Failure of a borrower to repay a financing.
- Fluctuation of foreign exchange rates.
- Fraud, incomplete security documentations, etc.
- Non-compliance with Shariah law and principles.
- Other events that may result in a loss to the Bank.

Types of Risk

1. **Shariah Non-Compliance Risk:** Shariah non-compliance risk is the risk of failing to meet Islamic principles in financial operations, leading to potential reputational, legal, and financial harm.
2. **Financial Risk:** Risks associated with financial markets, such as market risk, credit risk, liquidity risk, etc.
3. **Operational Risk:** Risks arising from internal processes, systems, or external factors impacting operations.
4. **Strategic Risk:** Risks associated with strategic decisions, market competition, changing consumer preferences, etc.
5. **Reputational Risk:** Risks that can damage the reputation of an individual or organization, impacting trust and relationships.
6. **Cybersecurity Risk:** Risks associated with the security of digital assets, including data breaches, hacking, malware, etc.

How to Mitigate Risk

- Mitigating risk involves identifying potential threats or uncertainties that could affect your goals or objectives and taking steps to minimize their impact. Here are some general steps to mitigate risk:
- Identify Risks: Start by identifying potential risks relevant to your situation. This could include financial risks, operational risks, market risks, regulatory risks, etc. Brainstorming, using historical data, and consulting with experts can help in this process.
- Assess Risks: Once you've identified potential risks, assess each one to determine its likelihood and potential impact. You can use risk assessment techniques such as qualitative or quantitative analysis to prioritize risks based on their severity and likelihood of occurrence.
- Develop a Risk Management Plan: Develop a plan outlining how you will manage each identified risk. This plan should include specific actions to be taken to mitigate, transfer, accept, or avoid each risk. Assign responsibilities and deadlines for implementing the plan.
- Implement Risk Controls: Put in place measures to reduce the likelihood or impact of identified risks. This could involve implementing internal controls, improving processes, diversifying investments, purchasing insurance, etc.

How to Mitigate Risk

- Monitor and Review: Regularly monitor the effectiveness of your risk management measures and review your risk management plan. Update the plan as necessary based on changes in the internal or external environment.
- Communicate: Ensure that relevant stakeholders are aware of the identified risks and the actions being taken to mitigate them. Clear communication can help in managing expectations and ensuring everyone is aligned in their approach to risk management.
- Stay Informed: Keep yourself updated on industry trends, regulatory changes, and other external factors that could impact your risk exposure. Being informed allows you to anticipate and respond to emerging risks more effectively.
- Build Resilience: In addition to mitigating individual risks, focus on building overall resilience within your organization or project. This could involve diversifying revenue streams, maintaining adequate liquidity, fostering a culture of risk-awareness and adaptability, etc.
- Seek Expert Advice: If you're unsure about how to mitigate certain risks or need additional expertise, don't hesitate to seek advice from risk management professionals, consultants, or industry peers.
- Document Everything: Keep thorough records of your risk management activities, including risk assessments, mitigation strategies, and any changes made to your risk management plan. Documentation helps in ensuring accountability and providing a reference for future risk management efforts.

The Islamic Perspective on Risk Management

There are numerous examples of risk management in the Quran and Sunnah. For instance, in Surah Yusuf, Yusuf peace be upon him, interprets a dream from the King of Egypt, included in the Quran.

"And [subsequently] the king said, "Indeed, I have seen [in a dream] seven fat cows being eaten by seven [that were] lean, and seven green spikes [of grain] and others [that were] dry. O eminent ones, explain to me my vision if you should interpret visions.“

- **(*Surah* Yusuf:43)**

The Prophet Yusuf (AS) then interpreted the king's dream, predicting that Egypt would experience seven years of drought followed by seven years of prosperity. Based on this interpretation, Prophet Yusuf (AS) devised a strategy for averting the disaster. The Egyptian people are to cultivate crops during the first years actively and then sell or conserve the harvests for use during the long draught period predicted in the future.

Another source of the Islamic perspective on risk management is found in the same Surah:

And he said, "O my sons, do not enter from one gate but enter from different gates; and I cannot avail you against [the decree of] Allah at all. The decision is only for Allah; upon Him, I have relied, and upon Him let those who would rely [indeed] rely.“

- ***(Surah Yusuf: 67)***

Takaful: A Shariah-Compliant Approach to Risk Management

Takaful operates within the framework of Islamic law, with Shariah scholars ensuring compliance with Islamic principles. It offers an ethical and socially responsible approach to risk management, aligning with the values of fairness, equity, and justice.

TAKAFUL

Takaful, the Islamic alternative to insurance, is based on the concept of social solidarity, cooperation and mutual indemnification of losses of 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. The Takaful contract so agreed usually involves the concepts of Mudarabah, Tabarru´ (to donate for benefit of others) and mutual sharing of losses with the overall objective of eliminating the element of uncertainty. Takaful is not a new concept in Islamic commercial law. The contemporary jurists acknowledge that the foundation of shared responsibility or Takaful was laid down in the system of 'Aaqilah', which was an arrangement of mutual help or indemnification customary in some tribes at the time of the Holy Prophet (pbuh).

The terms 'Family Takaful', 'Takaful Ta´awani' or just 'Takaful' are generally used for family solidarity in place of conventional life insurances. Other products available in various countries are General Takaful, Education/Medical Takaful, etc. Based on the nature of relationship between the company and the participants, there are various models like Wakalah (agency) Model, Mudarabah Model and the combination of agency and Mudarabah models. In the Sudanese Takaful Model that is preferable to majority of the contemporary Shariah experts, every policyholder is also the shareholder of the Takaful Company.

Basic Principle behind Takaful

The principle of "fortunate many helping the unfortunate few" is a concept recognized by Islam.

The Quran states in Surah Al-Maidah verse # 2:

"Help ye one another in righteousness and piety, but help ye not one another in sin and rancor".

Principles of Muwalat, Maaqil, and Kafalah are examples for its permissibility.

Takaful Global Models

Wakala Model

Definition: In the Wakala model, the takaful operator charges a fee (wakala fee) for managing the takaful fund on behalf of the participants.

Key Points:

- Fee Structure: Explain how the wakala fee is determined, usually as a percentage of the contributions.
- Role of Operator: Describe the responsibilities of the takaful operator in managing the fund.

Advantages:

- Transparency: Participants know upfront the fee they are paying for fund management.
- Stability: The fixed fee structure can provide stability in fund management costs.

Example: Provide a hypothetical scenario to illustrate how the Wakala model works in practice.

Takaful Global Models

Mudaraba Model

Definition: In the Mudaraba model, the takaful operator acts as a Mudarib (investment manager) and invests the contributions in Shariah-compliant investments.

Key Points:

- Profit-sharing: Explain how profits generated from investments are shared between participants and the operator according to a pre-agreed ratio.
- Losses: Describe how losses are borne solely by the participants.

Advantages:

- Incentive Alignment: The profit-sharing mechanism aligns the interests of participants and the operator.
- Potential for Higher Returns: Participants may benefit from higher returns if the investments perform well.

Example: Provide a hypothetical scenario to illustrate how the Mudaraba model works in practice.

Takaful Global Models

Mixed Model (Mudaraba + Wakala)

Definition: The Mixed Model in Takaful integrates Mudaraba and Wakala principles. It involves participants' contributions being invested through Mudaraba, with profits shared between participants and the operator. Meanwhile, operational activities are managed by the operator under Wakala, with a fee charged for services.

Advantages:

- Risk Diversification: Combining Mudaraba and Wakala allows for risk diversification.
- Operational Efficiency: The Wakala component ensures efficient management of day-to-day operations.
- Clear Roles and Responsibilities: It clarifies roles between participants and the operator, promoting transparency.
- Flexibility: The model adapts to market conditions and regulatory requirements while maintaining Shariah compliance.

Example: For instance, in a family Takaful plan, participants' contributions are invested based on Mudaraba, with profits shared. The operator manages operational activities under Wakala, charging a fee.

Types of Takaful

- **Family Takaful:** Provides protection against personal risks such as death, disability, illness, and savings plans for participants and their families.
- **General Takaful:** Covers property, liability, and other general risks faced by individuals and businesses, including motor, fire, marine, and health insurance.
- **Re-Takaful:** Reinsurance for Takaful companies to spread risk and ensure financial stability.

Features

- Firstly, the participation into a Takaful fund must be performed with utmost sincerity in order to help those faced with difficulties.
- Every policy holder would pay his subscription in order to assist those who need assistance
- Any member or participant suffering a catastrophe or disaster would receive a certain sum of money or financial benefit from a fund, as also defined in the pact, to help him meet the loss or damage

Operation of Takaful Fund

- The transactional aspect of the commercial activity of Takaful must be subject to the Islamic contractual laws in order to ensure its compliance with the Shariah .
- The Company involved in takaful business, as the operator, will accept payment of the takaful installments or takaful contributions (premium) from the participants (clients) for the takaful plan or takaful scheme they wish to participate.
- In order to eliminate the element of “uncertainty” in the Takaful contract, the concept of tabarru (to donate, to contribute, to give away) is incorporated in it. In relation to this a participant shall agree to relinquish as “gift” certain portion of his Takaful installments .
- For the service rendered as manager of the Takaful Operations the company will charge a management fee.
- The Takaful Fund, consisting of the contributions paid as Tabarru, will be further invested by the Company based on the principle of Al –Mudarabah, through which the element of interest (riba) will be replaced.
- All premium holders will participate in pofit and loss.
- Profit will be shared on agreed ratio.

Uses of Takaful

- Takaful can be used to cover
- Property like house, factory, mosque, offices
- Vehicles (car, motorcycle etc..)
- Goods (like during import or export)
- Valuables
- Health, accidents and Life

Financial Risk Management in Takaful

Takaful manages financial risks through risk-sharing and diversification. Investments are made in Shariah-compliant assets, promoting ethical business practices and sustainable growth. Governance and risk management frameworks ensure the stability and integrity of Takaful operations.

Q&A