

SOLVENCY OF TAKAFUL FUND: A CASE OF SUBORDINATED QARD¹

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Abstract

There are two elements important in formulating the solvency requirements of a Takaful undertaking namely the Takaful fund and Qard facility. It has been seen in some regulatory frameworks that the regulator puts a requirement on the Takaful operators to show that they are providing some financial support towards the solvency of the *Takaful* funds. This paper attempts to explain the measures involve the *Takaful* operator using their shareholders' funds to provide financial back\ing to support the solvency of Takaful funds through the practices of Qard facility, injection of assets into the Takaful funds and assignment or allocation of assets in the shareholders in the Takaful funds. The paper will focus on the nature of Qard and its basis in the primary sources of Shariah. Is it acceptable legally to subordinate Qard in the case of deficit, deficiency or drawn down of Takaful fund? Finally, the paper will analyze the legal ruling related to Qard and how it is different to conventional insurance practices.

Key words: Takaful fund, Qard facility, Takaful participants, Solvency, Subordinated Qard

¹ The views expressed in this paper are those of the author and do not necessarily represent the views of Islamic Financial Services Board (IFSB) and its management.

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1. Introduction

The solvency of *Takaful* fund in the actual terms and legality condition of Qard facility are significant impact in the capital requirements for *Takāful* undertakings. Since the legal and regulatory landscape of the *Takāful* industry is at still its infancy development, one of the challenges faced by the cross-border *Takāful* players includes the development and harmonization of the prudential regulation and supervision at the international level. Solvency of *Takaful* funds tends to be divided into two schemes namely: General Takaful and Family Takaful. Therefore, this paper tries to briefly examine the various analyses to the nature of *tabarru`* in *Takaful* and the resulting legal effects from each analysis to the issue of solvency of *Takaful* funds. The paper only focuses on that part of the Takaful funds which is allocated for coverage of risks and claims (risk funds), not the savings / investment portions of the funds (in family takaful) which clearly belong to the individual participants.

1.1 General Takaful

The general *Takaful* undertaking is a short-term contract where participants pay contributions and operators undertake to manage risk. The premiums paid by the participants are credited into the general Takaful fund, which is then invested and the profits generated are paid back to the fund. The IFSB-8 (December 2009) on Governance of Takaful undertakings has also explain that

General Takāful schemes are basically contracts of joint guarantee on a short-term basis (normally one year), providing mutual compensation in the event of a specified type of loss. The schemes are designed to meet the needs for protection of individuals and corporate bodies in relation to material loss or damage resulting from a catastrophe or disaster inflicted upon real estates, assets or belongings of participants. The *Takāful* contribution paid is pooled into the *Takāful* fund under the principle of *Tabarru`* to match the risk elements of the business that are inherent in its underwriting activities. Although investment activities in the General *Takāful* pool or fund are secondary to the underwriting activities, they may be important for the solvency of the fund, especially in the case of longer-tailed risks.

The contributors' payments are divided into management cost, risk management, surplus and Special Security Fund (SSF). Management cost is divided into commission, management cost and establishment cost, which covers bills and other miscellaneous expenses. The commission pays the staff salaries and is determined by the operator, which is deducted from the management cost. Commission can also be paid by the participant through mutual consent and agreement. The management cost is the cost of the establishment of the company.

A percentage of the participants' contribution also goes to the Participants' Risk Fund (PRF), which backs up the Takaful Company and handles the risk of insolvency. A certain percentage of a predicted amount is contributed to the Participants' Risk Fund (PRF), as a reserve for bankruptcy. For example, a company may estimate the probability of bankruptcy for the next 10 years and calculates that it will reserve RM10 million (US\$2.69 million) for back up. The participants then contribute 2% each to fulfil the reserve requirement of RM10 million (US\$2.69 million), which will be held by the Central Bank. This money cannot be touched by the Central Bank and will not earn or lose any interest. If the company becomes insolvent before the predicted 10 years, say in five years, the Central Bank will return RM5 million (US\$1.35 million) from the reserve to the company. If the company does not become insolvent after 10 years, the reserve remains untouchable. The purpose of this is to protect the benefits of the participants.

A proposal has been mooted to use the Qard facility in the SSF mechanism. From the RM10 million (US\$2.69 million) the company reserved in the Central Bank, it will get back RM1 million (US\$269,025) for every year it earns profit. So if the company earns RM1.5 million (US\$403,509) profit in the first year, the Central Bank will return RM1 million (US\$269,025) to the company. However, if this occurs every year, and the money that is returned is then used or invested, and the company becomes insolvent in the ninth year, there will be insufficient reserved funds left to cover the loss. To avoid these consequences, the returned reserved money could be credited to another company account where it could not be touched, specifically for back-up purposes. The Central Bank would no longer hold the reserve.

1.2 Family Takaful

Family Takaful, does not mean insuring one's life, but is a financial protection for the heirs or beneficiaries of the deceased (or insured) against future unexpected financial risk. Family Takaful is based on the principle of Mudarabah, which relies on the principles of mutual cooperation.

Family Takāful deals with the provision of financial relief to the participants and/or their family in the event of misfortunes that relate to the death or disability of the participants. This category of Takāful normally requires the Takaful Operator to engage in a longer-term relationship over a defined number of years with the Takāful participants, throughout which the participant is required to make regular instalment payments in consideration for his or her participation in the Takāful scheme. (IFSB-8 2009)

In Family Takāful, the paid Takāful contribution of a participant will usually be segregated into two accounts which feed two different funds. The first is the participant's investment fund (PIF), and the aggregate PIFs constitute an investment fund for the purpose of capital formation. The second is the participants' risk fund (PRF) which is a risk or Takāful fund – i.e. an element of the business that is inherent in the underwriting activities, and the contributions to which are made on the basis of *Tabarru'* commitment.

The segregation of the amounts credited to the PIF and the PRF, respectively, is commonly made based on certain percentages of the Takāful contributions paid, and this is normally part of the Family Takāful product pricing and design. The Takaful operator (TO) will indicate in the Family Takāful contract the distinction between the two accounts and their relative proportions within the overall contribution, which cannot be unilaterally altered throughout the term of the Takāful contract. Family Takaful consists of two types of funds: Participant's risk Fund (PRF) and Participant's Investment Fund Account (PIF). The PIF is treated in line with the principle of *Mudarabah*, while the PRF is treated on the basis of tabarru' commitment. If the risk occurs, beneficiaries have the right to claim policy value from the PIF, as well as the accumulated amount from the Participants' Risk Fund (PRF).

The segregation of funds is to facilitate better management of investments activities and risk management. The separation of risk and savings/investment components is deemed necessary to recognize the different ownership, purpose and risks associated with the contributions. Profit is distributed to participants according to their contribution or investment in the family Takaful fund, based on the terms and conditions applied by the company. The contribution paid by the participants in family Takaful is divided into four parts. A certain percentage of the premium paid is allocated for management costs, which comprises commission, management costs and the SSF account. The majority of the contribution paid for family Takaful is invested in PRF and PIF.

The management of reserves is the key element for having adequate capital resources in *Takāful* funds. However, the method of reserving may vary and to a certain extent could determine the transferability of these capital resources between the lines of business. The determinants of fund transferability depends on the contractual term or even legal framework that governs the operational aspects of the overall Takāful undertaking. Some Takāful products may have so-called ring-fenced structures, where part of the business is segregated from the rest of other operations in a ring-fenced fund. This ring-fenced fund should be understood as a contractual or legal arrangement whereby part of the assets or eligible surplus of the fund is strictly segregated from the rest of other lines of business and can only be used to meet the Takāful and ReTakāful obligations with respect to which the ring-fenced fund has been established. As a consequence, the capital resources in the undertaking held within the ring-fenced fund can only absorb the losses stemming from the risks associated with the ring-fenced portfolio and will not be available to meet the other fund obligations and cannot be transferred from the rest of the activity, on a going concern basis

2. Solvency of Takaful funds: a case subordinated Qard

According to the Shari'ah principles, Takaful Operator is commonly expected to provide a Qard facility (interest free loan) in case of a deficit in the Takāful fund and the repayment of Qard should be from future surplus arising from the Takāful funds. The most obvious reasons why the Takaful Operator is expected to provide a Qard are twofold. Firstly, it is hardly practicable to ask each and every individual Takāful participant to inject more funds into a fund in deficit and secondly, as the Takaful

Operator being an agent of the pool shares the risk of a deficiency, this falls within the mandate of Takaful Operator.

However, the terms and conditions of *Qard* on repayment and timing of the drawdown are unclear and not stipulated. The technical aspect of *Qard* is that has to be kept in mind is how to maintain fairness between different generations of participants, in particular future generations i.e. *Takāful* participants that newly joined a pool in a solvent position (without drawdown of the *Qard* facility) will be negatively affected as they might have to pay higher contributions or receive a smaller or no share of the underwriting surplus due to the need to make repayments of the *Qard*. There will be an obvious risk that *Takāful* participants may decide to leave the fund once the fund is in a deficiency if they are facing higher contributions or cannot expect to receive any underwriting surplus at the end of the *Takāful* contract. Hence, it might be difficult to convince any potential *Takāful* participants to join a pool that is in a technical deficiency i.e. below the solvency requirements. It is important to point out that according to the *Shari'ah* the setting of contribution levels so as to repay a *Qard* must not result in a higher fee or other remuneration for the Takaful Operator, as this would defeat the requirement that *Qard* be a benevolent or interest free loan

There are some regulators see that the *Qard* can be subordinated. While a Takaful firm or operator may exclude from its fund liabilities any amounts borrowed from the Takaful fund so long as the following conditions are met:

- The loans are free loans, established in accordance with Islamic principles, and the Shariah Supervisory Board (SSB) approves the terms and conditions of those loans.
- The loans rank for repayment upon winding up of the Takaful Company only ahead of the ordinary shares of the company and, for the avoidance of doubt, must be subordinated to all participants and other creditor obligations of the Takaful fund.

It is also explained that the Takaful undertaking allows for the capital to be contributed to the risk fund in the form of *Qard* facility. From the point of view of risk fund, since there is a separation between the Takaful operator's fund and the fund, *Qard* facility received might be viewed as capital in the risk fund, provided that is appropriately subordinated to the need to meet claims and can only be repaid out of future surplus.

To avoid so called "double gearing" using the same capital to cover two different risks, if *Qard* facility represented capital in the risk fund it could not also be recorded as an asset in the Takaful operator's fund even though it is expected to be repaid (James, 2009).

This regulatory position is contradicted with Shariah rules and principles based on the *Qard* contract which we will discuss in details in the below sub section. Mr. Sobia Maqbool has already mention in his speech that subordinated is not allow in Malaysia Takaful practice for Takaful solvency requirements he explained "The relative priority of claim of *Qard* offered by the SHF vis-à-vis other obligations, is also an important rating factor. For instance in Malaysia, *Qard* facility is not explicitly subordinated to the interests of policyholders (Takaful participants). In Pakistan, however, this is not the case

as the company is only required to pay *Qard* from underwriting surplus. This is considered positively as u/w surplus is arrived at after taking all claim expenses as well as associated reinsurance costs/benefits into account.”

Unlike conventional insurance, any surplus generated within the PTF is shared with the participants, which may prevent capital formation. Therefore, policy with respect to creation of surplus equalization reserve is considered important in terms of future assessment of claims paying ability. This reserve would only gradually grow upon time, depending upon the policy adopted by the Takaful operator and any credit thereof is built accordingly into ratings. In view of the practice of distributing surplus, the claims paying ability strictly from the PTF perspective may actually vary significantly from year-to-year and undertaking a firm-wide capitalization analysis therefore makes more sense. It is also considers the extent of ring-fencing amongst the surpluses generated by various product lines and the degree to which surplus from one may be used to off-set the losses on others. A more rigid structure may result in a greater need to call for capital from the SHF and may not be viewed positively.

It has been mentioned in the IFSB (2009) Standard on the solvency requirements for Takaful undertakings that However, the extent to which a Qard facility enables a Takāful undertaking to meet regulatory solvency requirements depends, inter alia, on the terms on which such Qard facilities are made available by TOs in the light of the regulations in a particular jurisdiction, including, in particular, those that determine the status of an outstanding amount of a Qard facility (that has already been drawn down as a Qard) in the case where a PRA enters into an insolvent winding-up. In such a case, there are two possible scenarios:

- i. Any outstanding Qard would rank *pari passu* with participants’ claims, so that the deficiency would be shared *pro rata*;
- ii. Participants’ claims would rank above any outstanding Qard.

Only in the second case should the Qard facility be considered to be fully part of regulatory capital. In the first case, it might be considered as making some contribution to regulatory capital.

In order to have Shariah view on subordinated Qard I have discussed this issue with Dr. Engku Rabia on the view of the SAC of Bank Negara Malaysia on this and she replied that this issue is still debate in the Shariah Advisory Council which it is not finalize yet, either to be *pari passu* or the Takaful operators to forgo their right in Qard facility. However, she told me that her personal view is the view of Dr. Ali al ghari in his paper (2009) “Qard facility in Takaful fund” in the IFSB seminar on Shariah issues related to Takaful undertakings in Madinah which stated:

“Origin of Takaful fund above is that this fund belongs to *Takaful* participants. Therefore, *Takaful* participants has to bear or responsible of paying back the shareholders this amount. Dr. Ali al-Ghari explained that

what of if the deficiency in the Takaful fund is still continuing which leads to a winding up.

Answer: If this is what happen to this fund, in the event of a deficit continue, the Takaful operators or shareholders have the right to forgo or donate this Qard facility for the benefit of Takaful participants, this will show the meaning of cooperative which is the core principles of Takaful undertaking. There is no restriction from Shariah rules and principles, it is permissible.”

3. The concept of Qard facility

The Shariah law allows Qard facility as a form of financial services for the Shareholders in Takaful undertaking to help and protect Takaful participants when the Takaful fund is in deficit and those who are in need of financial assistance. *Qard* in Shariah law may be obtained in two ways: (i) *Qard* with condition of repayment, and (ii) gratuitous loan without any compensation (*Qard hassan*). However, Shariah law does not recognize any loan with interest for the benefit of the debtor. It only recognizes gratuitous *Qard* or better known as *al-qard al-hasan*, but this term is the terminology used in the Holy Quran. Such term can not be use in Islamic financial have not been uncommon in human history among peers, friends and relatives. Kindness is encouraged in *Shariah* law.

3.1 Definition of Qard

The Qard has been defined in the IFSB-1 (2005) on Capital adequacy standard as a contract to provide amounts of loan (interest free) to others intended to allow the borrower to use the loaned funds for a period with the understanding that the same amount be repaid at the end of the period.

Therefore, qard is a kind of gratuitous loan given to the needy people for a fixed period without requiring the payment of interest or profit. The receiver of qard al-hasan is only required to repay the original amount of the loan.

3.2 Objectives of Qard facility

Shariah emphasizes to make brotherhood among the Muslims. The main principle of brotherhood is to care and share each other. Qard being a loan (without interest) can help the fellow Muslim brothers who need money but they do not have. Thus, qard al-hasan enhances brotherhood among the Muslims. The main objectives of qard al-hasan are:

- To establish better relationship between Shareholders, Takaful operators and the Takaful participant.
- The mobilization of wealth among all people in the society.
- To perform a good deed that is encouraged and appreciated by the Almighty Allah and His messenger.
- To strengthen the global Takaful industry and Islamic finance in general.

- To facilitate the poor to create new jobs market and business ventures by using their merits, skills and expertise.
- To establish a caring society.
- To eradicate unemployment problem from the society.

It can be also a missionary work for daw'ah activities by giving qard al-hasan to the non-Muslims, who might be attracted by knowing the beauty of Islam.

It can remove social and economical discrimination from the society, and

Finally, obviously there is a great reward in the Hereafter for giving qard al-hasan.

3.4 Qard in Qur'an and Sunnah

In many places of the Holy Qur'an, Allah has mentioned and encouraged His creature for qard by assuring better reward in this world and in the Hereafter. In the Qur'an Allah says,

He who will give Allah qard al hasan, which Allah will double into his credit and multiply many times. [Al-Baqarah (2): 245]

The Quran says:

If you give Allah qard al hasan. He will double it to your credit and he will grant you forgiveness. [Al-Tagabun (64):17]

Allah says:

Who is he that will give Allah qard al hasan? For Allah will increase it manifold to his credit. [Al-Hadid (57):11]

In the Hadith

The sunnah of the Prophet (peace be upon him) is also very clear on this issue. It is reported that the Prophet (saw) said, "in the night of the journey, I saw on the gate of heaven written, 'reward for sadakah is ten times and reward for qard al-hasan is eighteen times'. So, I asked the angel, how is it possible? The angel replied, "Because beggar who asked had already had something but a loanee did not ask for loan unless he was in need." [Ibn Hisham & Ibn Majah].

In another hadith

In hadith reported by Abu Hurayrah, the Prophet (peace be upon him) said, "whoever relieves a believer from a difficulty in this world, Allah will relieve him from his difficulty and Allah will facilitate him in this world and world hereafter." [Muslim]

The above Qur'anic verses and *Ahadith* directly and indirectly encourage the Muslims to give qard facility to the *Takaful* participants or any body who is facing financial difficulties, which will increase their credits in manifold and bring forgiveness for them in this life and hereafter.

3.5 Legal ruling (Shariah) of Qard facility in Takaful undertaking

Qard facility, being a contract between two parties requires some Shariah rules and principles which are applicable for other Islamic financial transactions. These rules and principles are as follows:

1. Both parties should be legally (Shari'ah) capable to enter into the qard contract.

It is unanimously agreed by the four schools of law that to enter into a contract, parties will be Matured (*baligh*), have reason (*'aqil*) and rashid (major with sound judgment). The Majelle has also incorporated the same principles. In the holy Qur'an, Allah says:

"Make trial of orphans until they reach the age of marriage; if then you find sound judgment in them, release their property to them." [Al-Nisa (4): 6].

This verse states that the age of marriage and the sound judgment is the age of majority, and thereby a major person is capable to enter into any transaction and the contract or transaction is considered valid.

In hadith of the prophet, which read as follow:

The Prophet (peace be upon him) said, "The pen is raised for three groups (of people) that is, they will not be responsible for their actions: the insane until they become sane, those who are sleeping until they are awoken, and the youth until they reach puberty."

The above hadith makes it clear that a person, who has not attained the age of puberty, may not be a responsible party in any contract or any transaction particularly Qard contract.

2. Ijab (offer) and qabul (acceptance) of the qard must be clearly made before entering into the loan contract:

All four schools of thoughts agree upon that *ijab* and *qabul* should be clearly indicated in the contract, otherwise, the loan contract may create dispute in future. In the loan agreement, there should have clear expression, collation and conjunction of the *ijab* and *qabul* between the parties.

3. The date of payment for Qard facility must be specified:

It is also agreed among the Muslim jurists that the date of payment should be mentioned in the Qard contract agreement. If there is no date is specified between the Takaful operators and Takaful participants, the transaction may lead to ambiguity and dispute in future among the Shareholders and the Takaful participant.

The evidence for prohibiting this action is that it was based on the Qard agreement of the Prophet's companions. When the Prophet migrated to Madinah munawwarah, he was informed that contracts of Salam were made

without stating specified time or amount, then the Prophet (peace be upon him) said,

"Whoever enters into a contract of Salam should specify the date of delivery and the amount of subject matter."

4. The Qard contract should be written down.

This ruling is based on a Qura'nic injunction. As Allah (s.w.t) says; "O you who believe! when you deal with each other in transactions involving future obligations for a fixed period of time reduce them in writing." [Al-Baqarah (2): 282]

Muslim jurists, however, differ on this condition. Majority of the Muslim jurists opine that it is not obligatory but strongly recommended. The reason given by them is that if both parties agree not to write, then it is no longer an obligation upon them to write down. The wisdom behind the writing down is to avoid future dispute. On the contrary, minority of the Muslim jurists like al-Tabari are of the opinion that it is obligatory upon the parties to write down the contract. It is submitted that the majority's stand seems more reasonable as they have given the option upon the parties whether to write it down or not.

5. Getting two witnesses.

The Qura'nic injunction is that there must have two male witnesses, if two men are not available, then one man and two women will have the same effect. As the Qur'an says:

"And get two witnesses out of your own men and if there are not two men, then a man and two women." [Al-Baqarah (2): 282]

It is very essential for the loan contract to be complied with this Qura'nic requirement to avoid future disputes.

6. Extra Payment:

It is very clear that in the Qard agreement, there will be no condition for extra payment; otherwise, it will be riba. It is however, advisable for the debtor to give some sort of gift to the creditor as a sign of appreciation of his voluntary deed.

In a hadith, Jabir bin Abdullah (may Allah pleased him) reported that I had the right (of Qard) on the Messenger of Allah, he had settled it and made additional payment to me. Again Abu Rafi' reported that the Prophet (saw) had borrowed a young female camel from someone and when he received zakat of camels, he ordered me to send a young female camel to the man as settlement of the loan. I said to him, "I could not find among the camels except a female camel which is ready for pregnancy". The Prophet (peace be upon him) said, "give it to him, indeed, the good person among you is he who settles Qard with something better."

is in fact not a hadith of the Prophet (saw) according to the hadith scholars as there is a doubt of its chain of narrators. Moreover, Muslim jurists have various opinions relating to extra payment over Qard. The Hanafi, the Shafi'e and the Hambali's stand is that every loan with profit is forbidden because of the statement "every

Qard which draws benefit is riba" if the profit is stipulated in the loan agreement, otherwise, the profit is permitted.

According to Malikis, the borrower may pay more than the capital quantitatively or qualitatively at the time of the settlement of the Qard provided that the Qard was used for commercial purpose. They restricted the extra benefit from the Qard if it was used for consumption purpose.

Indeed, the majority's view is more reasonable, it is up to the financier (person gives the money) whether to pay extra or not, regardless the Qard was for consumption or commercial purpose. The only restriction is that there should not be any stipulation for extra benefit in the Qard agreement.

7. Early demand to pay back:

Qard facility is a voluntary act by the creditor. However, it is not encouraged for early demand to pay back the Qard from the debtor. In the Holy Qur'an Allah says,

O you, who believe, fulfil your contract. [Al-Maidah :1]

And fulfill your covenant, for every covenant will be inquired into. [Al-Isra (17):34]

Then for having broken their covenant, we rejected them and caused their hearts to harden. [Al-Maidah (5):13]

In a hadith the Prophet (peace be upon him) said, "Muslims are bound by their conditions except a condition that changes halal into haram or haram into halal." [Al-Muatta of Imam Malik]

The Qur'anic and the Hadith injunctions indirectly provide that the creditor should not demand the loan amount from the debtor before the agreement matures or lapses. Muslim jurists, however, have given different views on this matter. According to the Shafi'e and the Hambali jurists, the creditor can demand the settlement from the debtor before the expiry period as he wishes. They have given the reason that the loan is voluntary and it can not compel any party to abide it. The Hanafi and the Maliki jurists, on the contrary, are of the views that the creditor can not demand the loan amount back until the time for settlement mature. Their reason is the above stated hadith of the Prophet (s.a.s).

It is submitted that the latter view is more reasonable as being beneficial to the creditor and should be accepted.

8. Guarantors:

In the case of the Qard facility, there can be guarantors. The guarantors of the borrower may be any person or the property of the creditor that is collateral security, such as, mortgage, charge etc. In case of the borrower's failure to pay back the loan (Qard facility) after the expiration of the time specified, his guarantor has to pay or the collateral security is to be valued for the repayment of the loan. But, Muslims should remember that a true believer should not delay to pay back his

obligations. As the Prophet (s.a.s) said, "Deliberate delay of a rich borrower to settle the Qard (interest free loan) is injustice." [Sahih Bukhari & Muslim]

4. Conclusion:

the treatment of the Qard facility is a fundamental issue. Any draw-down of a Qard facility into a PRF should in principle be repaid from future surpluses of the PRF and should not be subordinated as mentioned. the draw-down of the Qard facility will have been initiated with the intent of enabling the PRA to meet its regulatory obligations.

Shariah attempts to establish justice and eliminate exploitation in the society and prevents the accumulation of wealth in the hands of few people. Islam, therefore, absolutely prohibits riba as it is the root of all injustice in the financial transactions. Qard facility, on the contrary, being an interest free loan which is among the Shariah compliant contracts adopted in Islamic finance and takaful industry, that is why, the Qur'an and the Sunnah have much appreciated and encouraged for the implementation of Qard contract in the Islamic financial services.

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