

## Developing a Takaful Property Framework for Small and Medium Enterprises

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**Abstract:** Malaysia has been hit by massive floods at the end of 2014. During that time, almost 70% of SME investments in the form of equipment, machinery, inventory and finished stocks were completely destroyed. Is there a comprehensive Takaful protection scheme that could have covered the SME's property in times of disaster such as floods? Hence, this study took the initiative to formulate a comprehensive framework for Takaful property schemes with the intention of protecting SMEs' assets in times of floods. This study used both the qualitative and quantitative methods. Based on a survey of 251 SMEs, 88.5% stated that they lost between RM1, 000 and RM30, 000 in the form of tangible assets such as equipment, machinery and inventory, which directly impeded their business recovery process. Focus group discussions (FGD) involving 16 participants representing 6 agencies had in principle agreed to the SME-ART<sup>®</sup> scheme suggested by the researchers. This study suggested that the government formulate legislative policies to enable the implementation of the SME-ART<sup>®</sup> scheme through KPDNKK, SSM and SMECorp and make it mandatory for SMEs to take Takaful policies before renewing their business licenses.

**Key words:** Flood • SME Entrepreneur • Qualitative Method • Quantitative Method • SME-ART<sup>®</sup>Takaful Scheme

### INTRODUCTION

Several series of major floods have been recorded in Malaysia and the latest was in Kelantan at the end of 2014 and early 2015. The Kelantan floods had caused vast destruction including the destruction of property, roadways, agricultural land, public amenities estimated around RM932.4 million, the loss of 2600 homes (Berita Harian online) and human lives. Privately owned SMEs operating with limited resources were most affected by the floods, which saw some ceasing operations and some folding up due to overwhelming destruction of assets. In Malaysia, protection against the risk of floods is a national issue because the current Takaful/insurance scheme only covers basic perils such as fire and floods, which are only a choice stipulated in fire policies. Therefore, risk management plans need to be reviewed in order to provide a clearer picture to SME owners and corporate risk management policy makers. This is important to ensure the sustainability of SMEs and to

lessen the government's burden in the case of natural disasters. The main objective of this study is to obtain a deeper understanding of the contents and protection afforded by current property insurance schemes. This study also intends to identify risks and losses faced by SMEs when hit by floods. Besides that, this study also suggested a Takaful property scheme framework for dealing with the risks of floods to SMEs in Malaysia. Based on the objectives of this study, three research questions were drawn up. Are the current policies able to protect the SMEs' assets in times of floods? What are the risks and losses faced by SMEs' in times of floods? What form of Takaful property framework is suitable for SMEs when faced with the risk of losses caused by natural disasters such as floods?

This study is important because SMEs are the backbone of a nation's economic growth. Floods that impact SMEs are one of the environmental factors that are beyond control; one that has caused the disruption of business operations so much so that some has ceased

operation completely. Currently, there is no comprehensive Takaful property protection scheme specifically tailored for SMEs. Besides that, this study aims to determine the suitability of this Takaful scheme in order to make it mandatory for all SMEs when renewing their registrations. Lastly, this study was able to obtain feedback from three involved parties, namely SMEs, Takaful agents and agencies that have a direct relationship with SMEs such as SMECorp, SSM and KPDNKK regarding the suggestion to develop the SME All Risk Takaful Protection Scheme framework (*SME-ART*<sup>®</sup>) for SMEs in this country. Based on the findings of this study, it would be able to raise awareness of SMEs regarding the need to have Takaful protection for business assets in the case of disasters, such as floods.

### Literature Review

**Main Research Theory:** The Prospect Theory is a behavioural economics theory that explains the method used by individuals to choose between the alternative probabilities that involve risks, in which the probable outcome is known [1]. The financial and insurance fields are among the most prominent fields that could apply this theory, in which the attitude towards risk plays the main role [2].

**Flood Damage:** The history of devastating floods was recorded as early as 1931 in China, which involved 3.7 million loss of life [3]. Geographically, Malaysia is located outside the 'Pacific Ring of Fire' region and free from serious catastrophes and destruction caused by natural disasters such as earthquakes, typhoons and volcanic activity; however, it is prone to severe monsoon floods, landslides and haze [4]. Moreover, Ibrahim [4] found that Malaysia faces three main types of disasters, namely natural disasters, man-made disasters and the after-effects of man-made disasters. Floods caused by the overflow of rivers have been plaguing Kuala Lumpur and many places in the Klang Valley due to unexpected heavy downpours [5]. He also stated that these massive floods also occurred in Kelantan and other low-lying areas. Hence, insurance against floods is an alternative coverage that could allay the financial risks associated with natural disasters such as floods [6]. Malaysia had experienced 39 devastating episodes during 1968-2004, which involved natural or man-made disasters [4]. Ibrahim [4] found that 40% of natural disasters comprised of floods due to excessive downpours. At the end of 2014, a huge flood hit the east coast of Malaysia causing an estimated loss of more than RM1 billion. Baten and Nazaruddin [7] found

that devastating floods had brought about the destruction of human life and natural surroundings. The worst hit places in 2014 were the east coast states of Peninsula Malaysia such as Kelantan, Terengganu and Pahang. The flood had caused the loss of millions of ringgit and a large number of human lives.

Continuous rain had caused long-standing floods that affected urban areas and this posed severe consequences to the economy as most SMEs were located in urban areas. Besides that, a flood disaster brings dire consequences, especially to the economy, human life, infrastructure etc. Some of these effects are in the form of destruction to property and roads, loss of life, congested highways and pollution [7]. Among the causes of floods are that the size of water outlets that cannot handle the upsurge of water capacity and the inability of underground catchment areas (under major roadways) to handle huge volumes of water from up-river. In addition, barriers to water flow caused by sediments, rubbish and riverbank erosions cause drains to become shallow, which decreases the water-flow capacity and causes flooding. Besides that, public utility facilities that cross drains act as barriers and entrap rubbish as well as impede the flow of water [7].

To overcome these issues, risk management and transfer (including insurance) are important methods for reducing risks. According to Surminski [8], the insurance management approach related to floods or other losses accruing from natural disasters adopted in many countries differs in the rate of market penetration, type of product and operational mechanism of the insurance scheme. Estimations show that in developing countries, only 5% of losses due to natural disasters are covered compared to 40% in developed countries. Every year, floods cause severe destruction to developing countries and the majority of the destruction is related to the lack of knowledge, resources and mechanism to overcome it. Hence, the disaster map used by the Japanese is effective in evacuating people when disasters occur and it is suitable for flood management purposes in developing countries [9].

**Flood Insurance:** Flood insurance differs from country to country because it is a risk transfer mechanism that covers losses suffered during floods [10]. Lamond and Rowsell [11] stated that there are several approaches or methods in flood insurance programs recognised at the global level. First, is the insurance package supported by the private sector and re-insurance.

Table 1: Current Takaful Schemes for SMEs in Malaysia

|    |                      |   |   |
|----|----------------------|---|---|
| 1. | mySME Biz Partner    | Part 1 : FIRE COVERAGE (compulsory) Section 1.1<br>Basic fire perils (Fire, lightning and domestic explosion)<br>Additional perils (optional)<br>Flood<br>Storm & tempest<br>RSMD<br>Earthquake & Volcanic eruption<br>Explosion<br>Bursting/overflowing of water tanks<br>Aircraft Damage<br>Impact damage<br>Section 1.2<br>Fire Consequential Loss (Optional)<br>Section 1.3<br>All Risks (Optional) | Part 2: BUSINESS PACKAGE COVERAGE<br>Basic:<br>Burglary : {Money in Transit<br>{Money in Premises<br>Money: {Damage to Premises<br>{Damage to Drawers, Cash Registers & Cabinets<br>{Personal Accident (per person, up to 2 employees)<br>Fidelity Guarantee<br>Public Liability<br>Hospital Cash<br>Value Added:<br>Loss or Damage of Goods<br>Delayed Delivery of Goods<br>Client's Personal Effects<br>Infectious Diseases (Max 30 days)<br>Replacement of Anti-Crime System<br>Add-on Coverage for Part 2 (Optional)<br>Employer's Liability<br>Plate Glass including signboard<br>Group Personal Accident (up to 12 employees) |
| 2. | SME Flexi-Cover Plus | Unique flexibility<br>SME Flexi-Cover Plus gives the freedom to pick and mix coverage from a range of protection offered<br>COVERAGE:<br>Fire Protection*<br>*Fire Protection is an optional benefit.<br>Crime and Asset Protection<br>Increased Cost of Working<br>Burglary<br>Money<br>Personal Assault<br>Plate Glass  | Liability Protection<br>Public Liability<br>Employers Liability<br>The Liability Protection section must be selected with the Crime and Asset Protection section upon signing-up.<br>The Liability Protection section is not available as a stand-alone section.  |

The local government supports the second and the third is separate or an addition while the fourth is separate. Falkner and Hiebl [12] had identified numerous types of risks that could threaten the capability of SMEs and found that the risk management process in SMEs had a big effect on their business. Hence, adjustments to cater for flood risks would ensure that businesses continue to run even though hit by disasters.

There are several types of flood insurance schemes. First is the insurance package supported by the private sector and the re-insurance offers wide coverage to property owners at reasonable prices and at the same time ensures that the industry is viable and profit making [11]. Second is the government-endorsed flood insurance package. It is a compulsory clause meant for the protection against floods and other disasters stated in all property insurance policies and is known as the flood insurance scheme UK Version. In addition, the choice/addition is supported by the private market sector

and the re-insurance is known as the German Model, whereby the framework for the household protection ensures that the property is insured or protected against floods. Lastly, the choice/addition supported by the government, such as the American Model, is known as the National Flood Insurance Program (NFIP). It is subjected to political pressure in order to maintain low rates compared to actuarial rates in high risk situations. The NFIP is implemented by FEMA public sector agencies.

**Current Takaful Schemes for SMEs in Malaysia:** Floods have threatened SMEs in countries such as Brazil, the US, Japan as well as Malaysia and have ravaged lives, natural resources and nature resulting in health and economic losses due to disrupted businesses. Since Malaysia has a sizeable number of SMEs, the failure of the suggested scheme is low. Therefore, the government's involvement is needed in order to alleviate the risks faced by the

community, such as financial assistance in times of floods [13]. This study had identified the current Takaful scheme offered by Takaful operators to SMEs, which is the SME Flexi-Cover Plus and mySME Biz Partner. Table 1 details the coverage offered by both these schemes. At the time of this study, there has not been any specific study done in Brazil that the risks of floods related to any Takaful protection scheme. However, the majority of the previous studies were set to identify the general Takaful demand, have found results that SMEs need the protection of their business (see for example, [14,15,16]). This reveals that demand for Takaful by SMEs are based on the survival as well as growth and development of the firms. Thus, this study was undertaken to obtain input from Takaful operators and SMEs in an effort to create a risk-cover plan framework (including flood risks) that could benefit both parties.

**Methodology of the Study:** The framework for this study had used the mix research method involving both the qualitative and quantitative methods. The qualitative approach had focused on case studies and focus group discussions (FGD). The study's population consisted of SMEs (flood victims) from the 2014 floods in Kelantan. A good informant is one who possesses knowledge, experience, the ability to retrospect as well as the time and readiness to participate [17]. A qualitative study's sample size is small but it provides immense information based on the respondent's comments [18]. It details the context and meaning of situations and events of those involved and fellow researchers [19]. Thus, this study uses the probability sampling design for the whole research, although the findings from the research sample are not representative of the whole population. A certain part of the probability-sampling plan is more reliable than the rest and could offer some important indicators about potential and useful information related to the population. This study might adopt the purposive sampling method. The SME flood victims need flood insurance and the most pertinent person or body to provide information on this subject matter would be the flood victims. Eighty percent (80%) of the respondents had cooperated in this research comprising SMEs from Wakaf Che Yeh and Kota Bharu areas. The sample for this study consisted of owners of SMEs that were involved in the 2014 floods in Kelantan using the simple random sampling method. A briefing was held by the three researchers to ensure that the 251 respondents answered the questions accurately. In order to determine the amount of damage faced by SMEs in Kelantan, the study was carried out in seven (7) districts,

namely Kota Bharu, Pasir Mas, Tumpat, Tanah Merah, Gua Musang, Rantau Panjang and Kuala Krai. This was because many SMEs had their businesses in urban areas in each district. The research instrument used in this case was the questionnaire, which examined the amount of losses or the loss of business assets due to the floods. This was a convenient method because it was easy to investigate, reduced bias, easy to administer and convenient for the respondent too. In addition, this method showed uniformity, consistency and aided data processing [20].

This study also involved semi-structured interview process, non-participative observation and document analysis, in which the researcher was the main instrument for data collection [21]. The data were collected from eight representatives from SMEs through face-to-face as well as semi-structured interviews [22]. The interview was carried out in the Malay language and held at the interviewee's respective premises. This study had employed three experts from different backgrounds to review the questionnaire, namely experts in insurance, risk management and case study. Besides that, the main strategy in streamlining the questions is to re-evaluate the research questions that are frequently asked and to ensure that the scales are relevant [23,24]. For the purpose of this study, the best method would be to use the face-to-face interview in order to obtain accurate details and information [25]. Next, document analysis was used as a tool to gather data and information pertaining to the organization [26]. In this study, document analysis involved documents pertaining to population statistics from SME Corp, SSM, current property insurance policies from Takaful operators and danger maps from the JPS as well as flood information from MKN.

This study had also employed focus group discussions or FGD. This method was used to obtain input and views from each participant based on the questions adduced by the researcher. Two FGD sessions were held, one on the 4<sup>th</sup> August 2015 at the MTA headquarters and another on 12<sup>th</sup> November 2015, in Hotel Seri Pacific, PWTC. The first session involved participants who represented the Malaysia Takaful Association (MTA). Five participants were present on that day and the discussions focused on forming suitable product characteristics meant for flood disaster coverage. Participants representing MTA, SSM, SME Association, KPDNKK, PIAM, SME Bank and BNM attended the second FGD session. In this study, the focus group participants consisted of six representatives from MTA representing Takaful and re-Takaful; three from BNM, two

from SSM, one each from KPDNKK, SMECorp, SMEbank, SME@University and PIAM. The sessions were more related to the Takaful scheme framework suggested by the researcher and its effective implementation. The FGD sessions were recorded and the technique used in the sessions had adhered to the guidelines set by Kruger and Casey [27].

**Findings of the Study:** The study found that SMEs faced the risk of huge losses when floods hit their business locations. Even though the current Takaful policies in Malaysia offered protection to the perils associated with flood destruction and damage, the protection is offered separately, which could entail higher contributions and premiums. The SMEs found the current scheme to be unattractive due to the high premiums and this is evident the low penetration rate. A quantitative study was carried out in order to determine the losses faced by the 251

SMEs in Kelantan and found that 88.5% of SMEs claimed losses of less than RM30, 000 and only 2.4% had losses of more than RM100, 000. Table 1 below shows the loss incurred by SMEs.

Next, the study found that SMEs faced losses pertaining damage to buildings, equipment and stocks (raw materials and commodities). SMEs were not directly responsible for damage to business premises, as most of these premises were rented. Based on the case study, it was found that SMEs were severely burdened with physical loss in the form of equipment and stocks (raw material and inventory) and it took them some time to re-start their businesses. Table 2 shows a summary of the type of losses faced by SMEs. Besides physical losses, non-physical losses faced by SMEs such as loss of income, opportunities, employment and psychological trauma are much more difficult to assess.

Table 1: Loss Incurred by SMEs

| LOSS (RM)          | TOTAL RESPONDENTS | PERCENTAGE |
|--------------------|-------------------|------------|
| < 30, 000          | 222               | 88.5       |
| 30, 000 – 50, 000  | 13                | 5.1        |
| 50, 000 – 100, 000 | 10                | 4.0        |
| > 100, 000         | 6                 | 2.4        |
| Total              | 251               | 100        |

Table 2: Types of Losses Incurred by SMEs

| Respondent   | Type of Business                | Total Loss  |
|--------------|---------------------------------|---|
| Respondent 1 | Printing                        | Building: RM5, 000.00<br>Tools and Raw Materials: RM 10, 000  |
| Respondent 2 | Printing                        | Building: RM5, 000<br>Equipment: RM30, 000<br>Raw Materials: RM30, 000<br>Stock: RM70, 000                          |
| Respondent 3 | Boutique, Saloon and Gold Smith | Building: RM5, 000<br>Saloon Equipment: RM 20, 000<br>Saloon Stock : RM30, 000<br>Gold Smiting Equipment: RM30, 000 |
| Respondent 4 | Welding                         | Building , Equipment, Raw Material<br>Stocks and End Stock: RM20, 000   |
| Respondent 5 | Grocery Shop                    | Building: RM10, 000<br>Equipment and Stock RM30, 000  |
| Respondent 6 | Batik Factory                   | Building: RM10, 000<br>Equipment: RM10, 000<br>Raw Materials: RM30, 000<br>Stock: RM70, 000                         |
| Respondent 7 | Furniture Shop                  | Building: RM5, 000<br>Equipment: RM10, 000<br>Stock: RM200, 000   |
| Respondent 8 | Grocery Shop                    | Building: RM5, 000<br>Tools: RM5, 000<br>Stock: RM50, 000   |

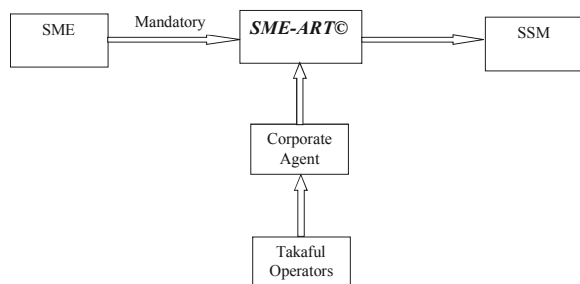


Fig. 2: The working framework of the *SME All Risk Takaful* (SME-ART®)

Next, this study had succeeded in producing a product in the form of basic protection extended to SMEs based on discussions with five members from Malaysian Takaful Association (MTA) represented by its Chief Executive Officer, its Executive, STMB representative as well as the researchers. The new product was tentatively called 'SME All Risk Takaful SME-ART®'. (Refer to Figure 2). Besides that, in relation to the method of implementing SME-ART®, Focus Group Discussions (FGD) with the industry consisted of representatives from the Ministry of Internal Trade, Cooperatives and Consumerism (KPDNKK), Malaysian Securities Commission (SSM), National Bank of Malaysia (BNM), Association of General Insurance Malaysia, SME Corporation, SME Bank, Malaysian Takaful Association (MTA) and Takaful Agencies in Malaysia were held to develop operational procedures meant for the implementation of this scheme. The discussions had produced a consensus regarding the method for implementing SME-ART® as a mandatory feature for SMEs. In principle, the Takaful authorities had agreed with the suggested scheme's framework to be adduced to a higher level in order to assist SMEs if they are face with flood disasters. The Takaful authorities would also benefit from this scheme since it would be mandatory for SMEs to contribute towards this scheme every time it renews its business licences. The government benefits from providing minimal assistance since if a disaster occurs, the cost of relief would be borne by Takaful. The government could then focus on assisting other parties that need help. Overall, it could be concluded that accepting the SME-ART® Takaful Scheme could help in reducing total losses during natural disasters.

## CONCLUSION

Based on the findings it could be concluded the current insurance/Takaful protection does stipulate

protection against natural disasters including floods and earthquakes. However, the said protection is an additional protection whereby SME must take the original protection and another add-on protection (flood) as well. The current protection concept severely burdens SMEs with high premiums; thus, making this scheme less attractive as evidenced by the low penetration rate. There are cases where Takaful agencies were reluctant to offer protection to SMEs in high-risk locations in order to avoid losses to the agency. This is against the principles of Takaful, whereby in principle, Takaful is built on mutual assistance between contributors and the ability to strengthen *ukhwah*. As an alternative to the current scheme, the researcher has developed a Takaful Property Scheme with the aim of protecting the property of SMEs in Malaysia.

This study had 251 respondents in the form of SMEs that were directly affected by the floods. They were surveyed and the information was used to obtain the rate of loss and risks faced during and after the flood. The findings showed that 88.5% of SMEs experienced losses of less than RM30, 000; while 2.4% experienced losses of RM100, 000. The SMEs experienced losses in the form of damage to buildings, equipment and stocks (raw materials and commodities). SMEs were not directly responsible for damage to business premises as most of these premises were rented. Nevertheless, the effects of the floods became apparent when goods for sale or inventory that were damaged were not covered by Takaful/insurance. This is because goods for sale were purchased in bulk and paid in instalments to the supplier. The effect of these losses cause psychological pressure that could paralyse the development of SMEs and most of the SMEs involved in the floods were *bumiputera* SMEs.

In efforts to alleviate the effects of floods on SMEs, the researchers had adduced the SME-ART® Takaful Scheme by designing the Takaful Property Scheme in order to protect SMEs' assets in the event of natural disasters such as floods. In doing so, the researchers had involved the industry, government agencies and SME representatives by obtaining their views and having them assess the development of SME-ART® Scheme. The FGD representatives invited to give their views about the Takaful Scheme were from Ministry of Internal Trade, Cooperatives and Consumerism (KPDNKK), Malaysian Securities Commission (SSM), National Bank of Malaysia (BNM), Association of General Insurance Malaysia, SME Corporation, SME Bank, Malaysian Takaful Association (MTA) and SMEs in Malaysia. One conclusion drawn from the discussions was that the FGD agreed with the Takaful Property Scheme design with the aim of dealing with the risk of floods faced by SMEs in Malaysia.

According to this scheme, the researchers suggested that the protection against the perils of floods be included as a basic protection clause and not as an additional protection clause as well as to make it mandatory for SMEs every time they renew their business licenses with MSC. The *SME-ART*<sup>®</sup> Scheme could be offered by registered Takaful agencies or through third parties appointed by Takaful via online. The MSC would only allow the renewal of company licence when supporting documents are complete and the cover note is certified by a registered Takaful agency. Therefore, the FGD stressed that procedures related to the implementation of the scheme needs to be discussed in detail because of the cost of new risks emerging from minimum additions to the present premiums.

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