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Takāful Risk Fund and Surplus Management

Analytics for Social Equity?

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Abstract: An important and significant feature of Takāful Model is the proper administration and effective management of risk fund and the takāful surplus distribution. Unlike conventional insurance where all premiums paid are exchanged in consideration for underwriting risk pool assumed by the insurance company in the form of risk transfer, Takāful contribution is based on the principle of mutual trust, mutual risk pooling, and mutual benefit based on (ta'aun) cooperation and the social contract of tabarru'. The tabarru' contribution to the risk fund exemplifies the social nature of the risk fund. Technically the nature of this mutual risk fund is based on social contribution intended to indemnify the participants as policyholders against peril arising from hazard. However, the issue of both moral and morale hazard may also arise due to the lack of policy and strategy in terms of governance and transparency of the risk fund. This article attempts to critically review the current takāful surplus management of selected takāful operator's model based on Shariah principles, rulings, and requirements; and the regulatory guidelines and policy documents. It will highlight the issue(s) of social equity among the shareholders, takāful operators, and policyholders and present the analytics of takāful surplus based on the different takāful operating models as specified by the Takāful Operating Framework. It will also examine the consequences of takāful surplus management reporting practices and the implications of the adoption of relevant international financial reporting standards. Finally, this article will attempt to articulate the analytics for social equity in Takāful.

Keywords: Takāful Operating Models, Takāful Surplus, Social Equity and Reporting Requirements

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Background

Since the introduction of Takāful Act 1983, the development of Takāful Malaysian industry has been gradual and less responsive as compared to Islamic Banking in accordance to the Islamic Banking Act 1983. In 2013 the Islamic Financial Services Act (IFSA, 2013) was promulgated to consolidate all financial sector legislations into a single Act. In addition, Shariah Governance Framework (2010, 2014, 2019) and Takāful Operating Framework (2010, 2019) were also introduced to direct and guide the developments of the Takāful industry.

Due to the similar prescribed insurance regime solvency requirements for the Takāful industry to ensure a solvent Takāful operating model, the takāful model mimics the risk appetite (TOF, 2019) and tolerance of insurance companies. In terms of Shariah governance 'Takāful purity' is maintained with the avoidance of usury, games of chance and gharar as well as not underwriting prohibited or non–halal risks as part of takāful general and family businesses.

The dichotomy and co-existence of two commercial Insurance and social Takāful realities, which are, Takāful institutions are to operate as 'social enterprises' within the cooperative philosophy but at the same time to operate as a commercially owned Islamic Insurance financial services have raised concerns on the 'social legitimacy of takāful' as compared to typical 'capital centric shareholder interest'.

In this respect potential cognitive dissonance could be exacerbated if the treatment of Takāful risk fund and surplus management are not consistent with the policyholders view of social reality but rather to the entity view of commercial reality.

This paper will articulate the regulatory framework of Takāful industry and analyse the issues of risk fund and surplus management practices to distinguish the social and economic realities of takāful risk and surplus management fund as compared to conventional insurance[1] where no risk or surplus is retained by the policy holder.

Paradox of Takāful Models and Transparency

The development of Takāful was primarily intended to serve the needs and welfare of the Insurance community. In particular it is a channel for 'Takāful inclusion'

1 Risk is transferred to shareholder reserves in conventional insurance.

to include those who avoid insurance products and services that contravene the principles and rulings of Shariah and hence excluded from Takāful protection and coverage. This is evident in 2020, where the Malaysian Takāful Association reported Takāful penetration rate remains low at 16.4% (RM1.06 trillion)[2].

Though the rationale for risk pooling and diversification of financial consequences arising from peril due to hazards is universal and accepted as law of nature 'fitrah' to attain 'Ta'mīn' peace of mind, the insurance risk transfer (legality) raised Shariah non-compliant issues. In conventional insurance, exchange contract of considerations denominated in the form of premium paid for risk transfer with underwriting of future claim from probable peril is uncertain (gharar)[3] subject matter. Furthermore, a potential 'windfall gain' may only encourage speculative behaviour on certain types of pecuniary liability policies. This has also been alluded to the prohibited 'maysir' gambling behaviour.

Despite the continuous efforts to campaign for the adoption of Takāful by both retail and institutional customers, low takāful penetration rate has been reported in most Muslim majority and other countries within the insurance industry[4].

Among the criticisms towards insurance is its opacity rather transparency due to capital centric investor focus orientation as well as lacking innovation, takāful literacy and talent. In technical parlance any premium paid exceeding sum assured claims, such excess benefits the shareholders as investors. On the contrary due to poor underwriting or catastrophic claims, deficit may arise and the shareholder reserves will absorb the loss after technical provisions are considered. All fund and management expenses are borne by the shareholders.

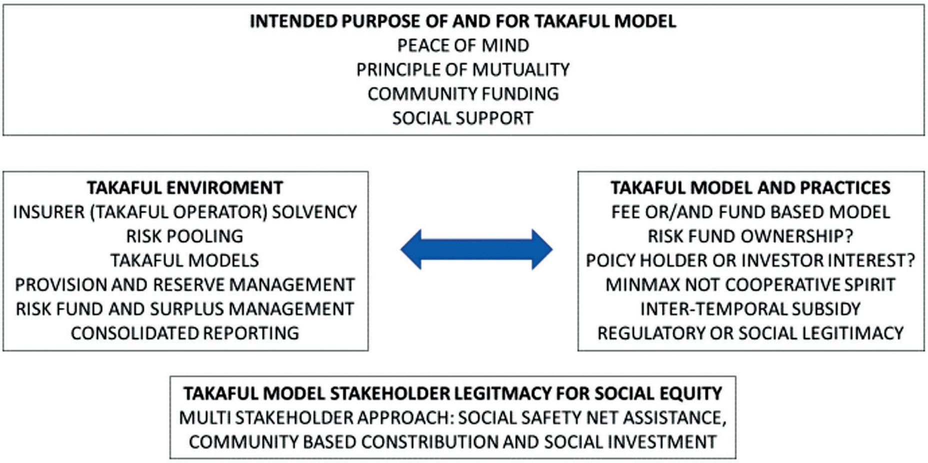
2 https://ringgitplus.com/en/blog/insurance/malaysian-takaful-industry-on-upward-trend-despite-covid-19-challenges-this-year.html#:~:text=06%20trillion%20while%20the%20number,-from%2055.6%25%20to%2057%25.

3 AAOIFI Shari'ah Standard No. (26): Islamic Insurance (2006) in AAOIFI Shariah Standards (2015)

4 https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/financial-services/me_fsi_insurance_takaful_0613.pdf

Figure 1.

Paradox of Takaful Models and Transparency



Source: Author

The above figure 1 presents the components of the Takāful system with intended takāful purpose, takāful models and takāful environment. The challenge to exhibit a coherent model is the representativeness of the takāful model within a conductive environment to achieve the intended purpose. In the final analysis, do the takāful models with its legitimacy provide social legitimacy of Takāful policies and practices that balance and harmonize the stakeholders' needs.

With the aversion of insurance in favour of takāful, takāful models are explored to redefine the nature (relationship), purpose and modus operandi of takāful business. Early discussions on the nature of takāful as social enterprise cooperative (Noor & Abdul Rahman, 2016) with the introduction of tabarru 'at principle (SAC, 2007) for takāful unilateral contribution as donation became the panacea for 'gharar' to respond to probable claim on peril. The potential social benefits from this relationship of mutual trust, goodwill and benefit are however not further explored as a social reality but limited to a 'juristic' solution to articulate the commercial legality and feasibility of takāful in the insurance industry.

The purpose of Takāful as mutual guarantee arrangement is somewhat subdued when the nature of underwriting is aligned to takāful operator (shareholder) preference, skills and expertise. In this sense the collective purpose to attain the 'peace of mind' based on the principle pf 'ta'wun' is now reiterated as benchmarking contribution as comparable premium for underwriting contracted claims from predetermined risk exposure. The likelihood of members to waive their claims to support the more in need does not arise unless ‘excess loss’ claim rider is imputed in the claim. Also, higher contributions similar to higher premiums will be eligible for ‘highly valued’ claims. The initial cooperative spirit is now price segmented and defined benefit partition to be priced by contribution vis a vis premium.

The modus operandi of Takāful evolves with Tabarru ’at principle which is commonly held by the industry. Significant focus is emphasized on the relationship between the policyholder’s fund and the takāful operator and not the relationship among the policyholders. The takāful fund which represents the relationship among the takāful policy holders are implied from the economic substance and consequence of the fund. Technically takāful fund is the participant risk fund (PRF) for both general and family takāful. However, the family takāful may have participant investment fund (PIF) in addition to the PRF due to the longer-term relationship among the policy holders for family policies. Regulatory provisions specify the requirements of the risk fund and indirectly determine the provisions to safeguard the interests of the policy holders. Other than takāful policy holders’ active contribution to the fund and claim relationships from the fund, most engagement and decisions of the fund reside amongst the takāful operator board, management and Shariah committee policy choices independent of the policy holders. Though management expenses are borne by operator (shareholders) and fund expenses are borne by policyholders. The policy separation of expenses recognizes distinct economic entities, namely the fund and the Takāful operator.

Various attempts in exploring appropriate Muamalah investment principles, ruling and related contracts such as Mudarabah contracts, social charity tabarru ’at, service Wakalah contracts as well its ancillary indemnity Kafalah contract are meant to structure the multiple combinations of Takāful Operating Model(s)[5] ((Hassan, 2019; Wahab et al., 2007) when the concept was launched in Sudan and later in Saudi Arabia. Yet, unlike its banking counterpart, takaful has been covered less in the literature on Islamic finance, and its workings are not fully understood. Shariah scholars have raised a number of concerns about the Shariah permissibility of the business models employed in the industry. This article examines the basic principles of takaful and then analyzes the mechanics of the two models most commonly used in the industry - namely, the mudarabah system that was developed by the Malaysians and the wakala agency.

5 Bank Negara Malaysia (2019), Takaful Operating Framework. Issued on June 26, 2019 [BNM/RH/PD 033-7]

Technically the initial role of the insurance policy holder as customer and claimant of the insurance company, is translated as multiple roles which are the investor (Mudarabah), the donor (Tabarru'at), the principal (Wakalah) and the mutual Guarantor (Takāful).

Since the contribution of the takāful policy holder is identified as a separate participant risk fund (PRF) held in trust by the Takāful operator, the nature of the PRF varies in its local standi by virtue of its originating contract.

Due to the multiple roles based on the various contracts, this study will highlight the issues of takāful risk fund and surplus management with respect to the solvency of the Takāful operator as well as the fund.

It will also attempt to suggest relevant takāful surplus management analytics to assess the likelihood of takāful risk fund to retain its social enterprise nature as social equity within the Takāful Operating Framework (TOF).

Research Objectives

With the decreasing and low takāful penetration rate within the insurance industry and the challenges of meeting insurance solvency regulatory requirements as well as the indeterminate takāful identity as a social or commercial fund, this study attempts an acid test to highlight the pertinent issues relating to the treatment and reporting of takāful risk fund and surplus management. The research objectives are specified as follows:

a. To articulate and assess the regulatory requirements and provisions of takāful risk fund and surplus management from a stakeholder perspective.

b. To identify the Takāful Operating Model orientation and analyse takāful participant risk fund and surplus management treatment as well as reporting issues.

c. To determine relevant arrangement to enable takāful risk fund and surplus management to fulfil its social purpose and legitimacy.

Articulating Regulatory Frameworks for Takāful Social Legitimacy in Malaysia

The takāful operating and reporting environment are significantly regulated by the Islamic Financial Services Act (IFSA) 2013, Shariah Governance Policy (SGP) Framework and Takāful Operational Framework (TOF).

Part II Article 6 of Islamic Financial Services Act (2013)

The principal regulatory objectives of this Act are to promote financial stability and compliance with Shariah and in pursuing these objectives, the Bank shall—

(a) foster—

(i) the safety and soundness of Islamic financial institutions;

(ii) the integrity and orderly functioning of the Islamic money market and Islamic foreign exchange market;

(iii) safe, efficient and reliable payment systems and Islamic payment instruments; and

(iv) fair, responsible and professional business conduct of Islamic financial institutions; and

(b) strive to protect the rights and interests of consumers of Islamic financial services and products.

From the regulatory financial industry perspective, financial soundness of institutions and financial stability of the system are the key foundations to promote sustainable growth and stability of both conventional and Islamic financial institutions particularly in a dual banking and dual legislation system in Malaysia.

The promulgation of the Islamic Financial Services Act 2013 was introduced at the same time as the Financial Services Act 2013. The joint pronouncement reflects the importance and distinct nature of both legislations regulating and supervising a two-sector conventional and Islamic financial sectors. These are specified by licensure as well as supervision according to prescribed guidelines, policy documents and circulars. A peculiar feature specified for the Islamic financial sectors are the Shariah Governance and contract standards as policy documents.

> 15.1 The CEO, in leading senior management, has primary responsibility over the day-to-day management of the IFI. This includes ensuring that the IFI's operations, business, affairs and activities comply, at all times, with Shariah. (SGP, 2019)

In particular Senior management and key responsible persons role are specified with reference to the following Shariah control functions.

> 16.3 An IFI must ensure effective management of Shariah non-compliance risk which requires the following functions to be performed on an ongoing basis:

(a) Shariah risk management;

(b) Shariah review; and

(c) Shariah audit.

Since the codification of the Ottoman Mejelle[6], this phenomenon presents an interesting and significant development and contribution to the Islamic financial services industry. The discourse and adoption of the Shariah governance and Shariah contract standards policy documents arise from the central bank's active involvement in Accounting, Auditing, Organization of Islamic Financial Institutions (AAOIFI, 2015) Shariah standards deliberation as well as its leadership to Islamic Financial Services Board (IFSB) prudential standards. Other Central bank engagements including International Islamic Liquidity Management (IILM) and other related Organization of Islamic Cooperation (OIC) and Islamic Development Board (IDB) agencies which respond to global monetary policies and system developments also contributed to the establishment of comprehensive framework and precise standards for Maqasid Al Shariah goals, principles and rulings.

From a stakeholder perspective (Iqbal & Mirakhor, 2004) for proper, appropriate and effective governance of Islamic financial services industry (IFSI), *to what extent does the regulator focus on financial soundness which are aligned to solvency, profitability and liquidity to sustain investors' as well as stakeholders'' confidence and trust*. The solvency margin of insurance and takāful models, represent the primary indicator of soundness of the institution to sustain and provide adequate coverage to the policy holders.

11.3 In evaluating the takāful risks, a licensed takāful operator shall ensure that the–

(a) takāful risks to be accepted are consistent with the licensed takāful operator's risk appetite and underwriting capacity;

Similarly, the policy holder protection accorded to both conventional and Islamic policy holders are to protect and preserve the rights as well as safeguard their interests in the insurance and takāful dealings. Despite the distinct dual legislation of Shariah compliant business of Takāful, the primary economic substance of takāful risk exposure and underwriting are legally recognized as common and similar to insurance probity.

6 AL-MAJALLA (The Ottoman Courts Manual (Hanafi)

Though the financial provisions of IFSA (2013) specifies the distinct shariah compliance requirements supported by the institutional governance structure and control functions of SGP (2019) and TOF (2019) the fundamental distinction of compliance will be monitored based on the observation of Shariah contract standards policy documents. The Shariah Compliance Centric approach directed to the Takāful Operators has aligned to the authenticity and traceability of Shariah evidences as well as the validity and reliability of the arguments presented as contract requirements. The issue of equity and trust in law and governance is much less emphasis and hence need to be discussed or addressed in the interest of takāful policy holders. Unlike the conventional policy holders who do not retain the rights nor control on the premiums paid, takāful policy holders are given the assurance that the risk fund and any surplus arising from such funds are to be governed in the interest of the Takāful policy holders.

Hence the sufficiency of the regulatory provisions to protect and preserve the rights as well as to safeguard the interests of the policyholders need to be re-examined. This is pertinent to display a broader representation of stakeholder concern not only on Shariah compliance but to restore and enhance policy holders' confidence. This ultimately will bring a more refreshing perspective to social legitimacy of Takāful within the insurance industry.

Origination of Risk Fund and Surplus from Takāful Models and Contracts

Takāful or mutual guarantee facilitates the risk pooling of tabarru' funds as contributed by the policyholders for both family and general takāful purposes. In essence, it is based on the principle of mutuality where all policyholders mutually agree to donate for adversity upon the escalation of a claim. Any unutilized balance is set aside for future risk provision as advised by the actuaries and if the takāful surplus exceeded the required provision, the central bank allows sharing of the surplus between the takāful operator and policy holders whose policy is active. The Takāful Operator share however should not exceed 50%.

On the contrary, if claims exceeded contribution, risk fund may result in a deficit and to safeguard the solvency margin of the fund and entity, the takāful operator is to provide soft loan (Qard) to cushion the deficit and hence meeting the targeted solvency margin. The Qard is repayable from future surplus when contribution plus investment yield exceeds the claim. Hence any surplus distribution occurs only after adequate risk provisioning by actuaries and no Qard remains outstanding (Khan, 2015; Salman, 2014; Soualhi, 2016) its main competitor is the insurance industry and Takaful industry is relatively new compared to the insurance industry. Since most of the Takaful products are offered by the commercialized companies similar to the insurance industry, Muslim scholars have gradually created Takaful models which will be suitable for the Takaful operators in order to be viable in terms of profitability, risk management while abiding the Shari'ah requirement. The purpose of this paper is to make a comparison among the Takaful models from seven aspects, including splitting the participant contribution, payment for Re-Takaful contribution and reserves, operating expenses, surplus sharing, profit sharing from the PIF, claims, surrender, maturity and interest free loan. Seven Takaful models, namely, Cooperative ((Taa'wuni).

The current takāful surplus management practice is prescribed by relevant regulations consistent with the Takāful Operating Framework 2019 and the Shariah governance Policy Document 2019 as well as the Islamic Financial Services Act 2013. A licensed takāful operator must manage underwriting process effectively to avoid adverse selection and to ensure that the takāful funds are sustainable in the long run [11.1, TOF 2019]

Issues on Origination of Risk Fund and Surplus

Several issues could be identified and observed from the Takāful surplus deficit origination from the risk fund as follows:

a. Inter-temporal policyholders regular or lumpsum contribution between short term general takāful and long-term family takāful policies.

b. Pricing of takāful contribution to risk fund in lieu of takāful models, namely, wakalah fee model and hybrid wakalah-mudarabah fee and profit-sharing incentive model as well as other surplus administration charges or investment fees to the takāful operator.

c. Status of takāful fund as tabarru' (donation) fund and is non-refundable or redeemable except for claims; or as investment fund with contingent claim upon escalation of claim.

d. Takāful regular drip contribution or direct allocation to risk fund.

e. Perpetual nature of risk fund subject to outstanding (expiry) policy holders' contribution of the fund.

f. Consolidation or segregation of Takāful funds among different class and category of policy holders.

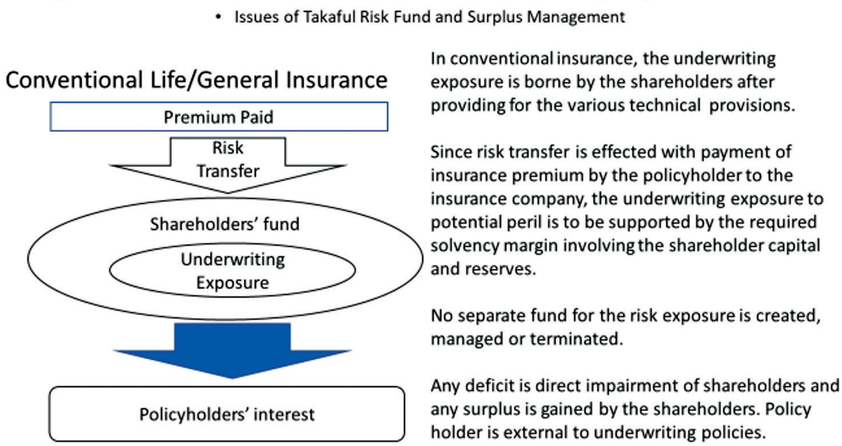
g. Takāful surplus sharing with existing and takāful deficit subsidized by future policyholders.

h. Takāful surplus social distribution policy as corporate social responsibility

i. Takāful deed covenants to appropriately protect policyholders' rights and effectively safeguard their interest.

The above have been long standing issues in the Takāful industry and need to be analysed and relate from stakeholder governance perspective as well as its social legitimacy.

Figure 2.
Conventional Insurance Underwriting Exposure

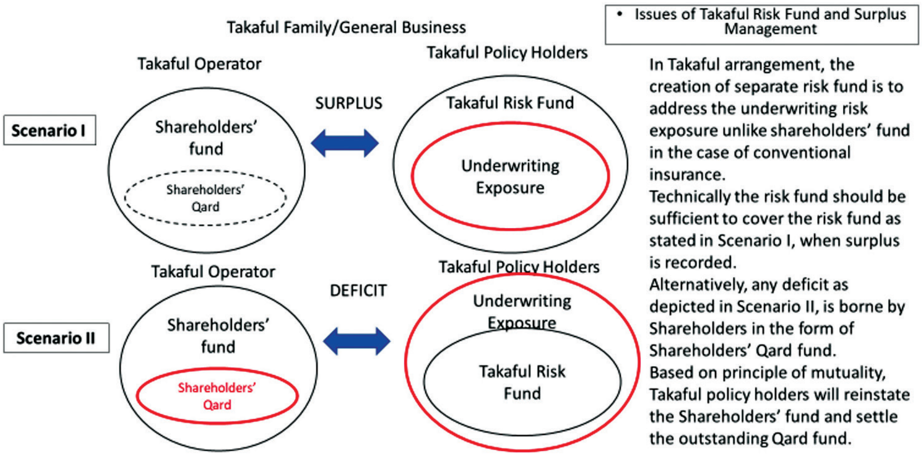


Source: Author

Figure 2 depicts the typical conventional insurance underwriting exposure, where risk transfer is executed with the insurer as the underwriter. Hence underwriting risk exposure is borne by the shareholders subject to the premium paid by the policy holders. Any deficit when claims exceed premium will be borne by the shareholders. Hence any impairment will directly affect the shareholders' reserve.

Figure 3.

Takaful Operator Underwriting Exposure



Source: Author

Figure 3 depicts the variation of Takāful arrangement as compared to conventional insurance. Two contrasting scenarios are exhibited. Scenario 1 describes the situation when Takāful PRF exceeds underwriting exposure and claims. Takāful surplus is recorded and may be shared with shareholders in certain jurisdictions. On the contrary, Scenario 2 describes the situation when underwriting exposure and claims exceed the Takāful PRF. Takāful deficit is now recorded in the shareholders' account as Qard (interest free loan) to the Takāful PRF to sustain the Takāful model. Both the takāful operator and Takāful PRF are separate economic entities in substance. However, the latter lacks legal and social legitimacy in representing the interests of policy holders.

Inter-temporal Policyholders Contribution

Inter-temporal policyholders regular or lumpsum contribution between short term general takāful and long-term family takāful policies in the risk fund did not specify the right to recourse from non-eventful claim. In other words, upon a non-claim event, the fund is retained at the discretion of the takāful operator.

Takāful family policies are generally intended for a longer period, where the contribution is a form of planned saving or annuity to enable a sizable claim upon occurrence of adversity or lump sum drawdown to facilitate planned disbursement like education and other financial needs.

Takāful general policies, however, are generally intended for shorter period and may be renewed annually to cover exposures as a form of indemnity claim. They may include sum assured for mortgage, fire, medical, motor vehicle and other liabilities with potential measurable peril from identifiable hazards.

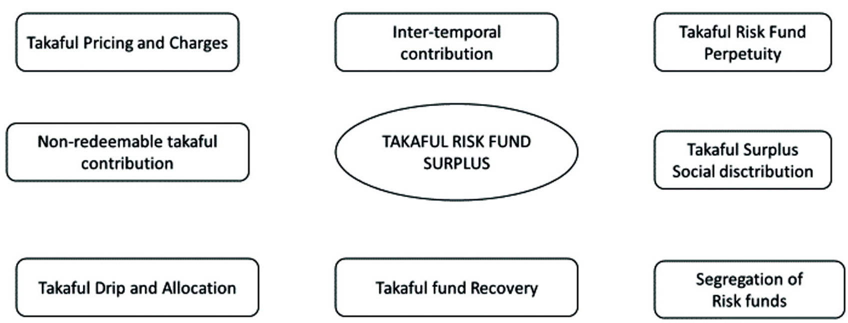
Annual review of claims vis a vis contribution to the fund will record either a surplus or deficit. With the recent separate family and general takāful licensing business as separate entities, higher level of transparency of funds are however expected from both entities.

Technically each takāful fund financial position will be determined by the takāful policies including actuarial estimation. Hence some takāful funds such as motor and medical may be in deficit due to high claims ratio whilst fire and mortgage could be surplus with low or moderate claims ratio.

Hence, should the past non-recourse contribution in surplus be shared and in case of claims in deficit (qard) be subsidized by existing policy holders only? The decision and response to the surplus or deposit arising from periodic review of the takāful risk fund status affects the inter-temporal policy holder's interest. Unlike conventional insurance where such surplus or deficit is wholly or exclusively reported as shareholder's reserve due to its underwriting and claim management decisions, takāful risk fund is intended to safeguard the policy holders' interest of future claims. The anomaly is present in the underwriting, claim and management decisions that are at the discretionary of the takāful operator with shareholders' solvency interest with specific technical regulatory provisions. Existing financial reporting and disclosure lack distinction between fund status and management related efficiency expenses to provide clarity on the loss exposures of the fund as compared to operational losses of the takāful operator.

Figure 4.

Issues Takaful Risk and Surplus Management



Source: Author

Figure 4 depicts the seven issues relating to takāful participation risk fund (PRF) that are faced by takāful operators in the industry. These issues are not isolated and related to each other with reference to TOF (2019). Transparency and disclosures to policyholders are pertinent to these issues to gain the confidence and legitimacy based on the types of takāful models are specified.

Pricing of Takāful Contribution to Risk Fund

The pricing of takāful contribution to risk fund is in lieu of takāful models, namely, wakalah fee model and hybrid wakalah-mudarabah fee and profit-sharing incentive model as well as other surplus administration charges due to or investment fees earned by the takāful operator.

In a pure takāful wakalah model, the takāful operator earned wakalah fees to manage the participant risk fund (PRF) and in certain cases the fees are paid in advance and takāful drip is adopted over the period. Where designated Takāful family contribution is contributed to participant investment fund (PIF), either investment fee and/or profit sharing from investment yield is also recognized. The hybrid takāful model apparently is more flexible, as the Takāful operator options to mitigate the takāful risk funds and generate income or compensation from its services to sustain its operations could be derived from wakalah fees upon 'pool' underwriting, profit sharing from PIF investment yield and PRF surplus and administrative charge on PROF surplus. This implies a preferred model for takāful operator as well as maintaining its solvency margin and meeting policyholders' expectations.

Based on the principle of mutual trust, goodwill and benefit, takāful policy holders contribute as donation to the risk fund as specified by actuary on the likelihood of the claim by the respective policy holder as well as to ensure the sustainability of the risk fund.

The underwriting exercise by the takāful operator is compensated as an agent to protect and safeguard the fund as well as to properly administer any claims arising from the fund. Any additional services rendered such as investment of the risk fund surplus or investment fund will be granted a different incentive fee compensation.

Wakalah Model Takāful Operator is compensated with upfront or proportionate wakalah fee. In case of surplus, additional administrative charges may be imputed over above the agreed surplus sharing ratio not exceeding BNM prescribed 50% of the surplus including investment yield.

The Hybrid Wakalah Mudarabah model Takāful operator on the other hand is compensated for the profit-sharing ratio from investment yield of the fund as well as administrative fees charged to the risk fund. In addition, 50% of surplus fund is shared amongst the takāful operator and policy holders.

Due to the inter-temporal contribution and allocation of risk fund, to what extent does the pricing of risk fund contribution is influenced by *a-priori* and *a-posteriori* risk assumptions or evidence; and surplus sharing factors to ensure sustainability of the fund need to be determined and disclosed.

Status of Takāful Fund as Tabarru' (Donation) Fund or as Investment Fund With Contingent Claim

The status of takāful fund as tabarru' (donation) fund and is non-refundable or redeemable except for claims; or as investment fund with contingent claim upon escalation of claim.

The ambiguity of the status of risk fund is highlighted when decision needs to be made is to safeguard the rights of the policy holders as well as to adequately compensate the takāful operators and shareholders.

Donation as a unilateral contract is the panacea to avoid gharar (uncertainty) arising from an exchange contract for a potential contingent claim on the occurrence of a peril. However, there is policyholder expectation that unutilized surplus is to be distributed to policyholders. Hence it presents a dilemma to takāful operators in terms of clarity of policy holders' choice.

Alternatively, if initial contribution is investment and only on contingent claim basis the fund is donated to address the claim, the policyholder as 'investor first' followed by 'donor who contributes to clarity'. However, the adequacy of risk fund is subject to investment impairment since its status is investment and not a secured risk fund for claims.

This issue has raised the question of whether MFRS 17 or MFRS 15 financial reporting standards are appropriate for Takāful fund financial reporting.

The current status of Takāful risk fund has not specified the 'contract of claim from the fund' but however implied the 'eligible claim' contingent upon the mutually agreed takāful event. Currently, the regulatory provision requires the Takāful Operator to enable such claim by Qard if the takāful risk fund is in deficit. It can be implied that the regulatory provision to protect and preserve the rights of the policy holders as well as to safeguard their interests are commendable.

Takāful Regular Drip Contribution or Direct Allocation to Risk Fund

In terms of risk fund sustainability and solvency, the manner of allocation of takāful contribution to the risk fund is pertinent. In particular, takāful contribution could be in the form of regular instalment (annuity) or lump sum (single) payment for the takāful period.

In the case of annuity payment, regular direct contribution may be specified to be direct proportionate contribution to the risk fund and on the other hand when it is single advance payment, takāful drip will be assigned to the risk fund as well as earned wakalah fees (where relevant).

The recognition of the takāful contribution to the risk fund may vary with takāful model and takāful operator practices. These will impact on the potential and likelihood of Takāful surplus or deficit due the timeliness and effectiveness of the contribution (Noordin, 2013; Soualhi, 2016)which is overwhelmed by banned elements such as gharar (uncertainty.

Takāful allocation contribution practices to the risk fund may vary and affect the solvency margin of the risk fund as well as potential surplus or deficit. Hence there is a need to distinguish and analyse the impact of such practices.

Perpetual Nature of Risk Fund

The perpetual nature of risk fund is subject to outstanding (expiry) status of policy holder's contribution to the fund. In cases where new policies are introduced with enhanced product features and riders, the former policies will mature whilst the outstanding risk fund is maintained for future active policy holders.

In terms of inter-generational contribution of claims, surplus and benefits, the perpetual nature of the risk fund and the continuing interest of the participants may not be coherent and consistent. From a time-varying perspective, if the risk fund status is surplus from prior policy holder contribution, it subsidizes the current policy holder with lower contribution to risk fund. On the contrary if the risk fund status is deficit from prior policy holder claims, the current policy holder needs to subsidize the risk fund with higher contribution. At all times the Takāful Operator Qard is needed in order to maintain the targeted solvency margin of the required risk fund.

With reference IFBS Working paper 08 (WP-08), a survey was conducted which examined the practice of distributing surplus before full repayment of a qard among the respondent TOs. Only one jurisdiction permits the distribution of surplus prior to the full repayment of a qard, whereas other RSAs have no guidelines on the settlement of a qard before any surplus distribution, thereby leaving TOs to be guided by their internal policy. As one TO stated, "the determination of surplus distribution lies with the board of directors. Thus, they have the discretion to retain, and distribute part or the entire surplus depending on the circumstances with approval from the supervisor."

In addition, the survey highlights the differences among RSAs regarding sharing of underwriting surplus. One-third of the RSAs prohibit the sharing of underwriting surplus, whereas another one-third of the respondents permit the sharing of underwriting surplus. It is noted, however, that the sharing of underwriting surplus is not directly related to the takāful model in operation. The sharing of investment and underwriting surplus is allowed in jurisdictions where the pure mudarabah, tawuun (cooperative) and waqf–mudarabah models are practised.

On the other hand, the distribution of underwriting surplus (i.e. as a performance fee) is allowed in some jurisdictions that have adopted a pure wakālah model. This is in addition to the upfront wakālah fees charged to the PRF. The takāful model in operation across the jurisdictions is distinct, indicating lack of a clear and definite pattern across jurisdictions. Then again, the distribution of underwriting surplus prior to full repayment of qard is permitted by few RSAs (13.3%), showing that the practice as such is not widespread.

The inter-generational time varying policy period contribution to risk fund has raised the issue on inter-period cross subsidy or otherwise amongst policy holders other than support by Takāful Qard funding. Hence to what extent does takāful policy contribution and claims management affect the status of takāful surplus fund.

Consolidation or Segregation in Reporting of Takāful Funds

The consolidation or segregation of Takāful funds among different class and category of policy holders may be attributed to the nature of policies, product features and risk exposures as well as the degree of homogeneity or heterogeneity of the policy holders.

Typically, both family and general takāful provide a range of takāful policies and their variations in terms of different perils, risk exposures and claims ratios. Hence a common risk fund may require a higher contribution to compensate from high claims ratio experience as compared to lower claims ratio experience. Hence consolidated reporting of takāful funds similar to conventional reporting may result in lacking disclosure to the respective policy holder's information needs.

The policy implications on consolidation or segregation of risk funds in terms of sustainability, transparency and equity to policyholders given the variation of policy types and risk exposures may be impaired due to lack of social equity reporting(Nazri et al., 2020) in terms of transparency and corporate social responsibility.

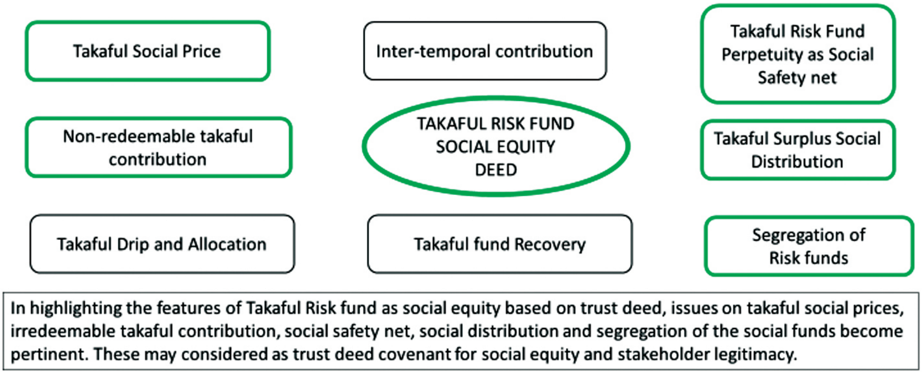
Takāful Surplus Social Distribution Policy

Takāful surplus social distribution policy as corporate social responsibility is practiced amongst takāful operators on a selected basis. In certain cases, these are done with a view to discharge the joint social responsibility of both the policy holders and takāful operators, when takāful surplus are distributed for charitable purposes. In most cases CSR is a publicity campaign and marketing tool to exhibit socially responsible contribution or investment.

In certain circumstances, this phenomenon can be observed when takāful surplus distribution could not be distributed to policy holders whose policy has matured and not identified. At the discretion of the takāful operator with consultation of the Shariah committee, CSR distribution is made accordingly.

Should a clear policy of social distribution be specified to allow Takāful operator to distribute such surplus upon meeting certain criteria such as settlement of any outstanding Qard and targeted solvency margin? Clarity in terms of policy on social distribution is key to advance further the social role of takāful and the social equity function of the risk fund in fulfilling the needs of the community (policy holders, stakeholders and society.

Figure 5.
Highlights of Takaful Risk Fund as Social Equity



Source: Author

Need for Policyholder Legitimacy of Takāful Risk Fund for Social Equity

Tabarru' risk fund is a technical provision that does not reflect any defined rights and obligations amongst the policyholders. Takāful Operator maintain this fund as its obligation to the policy holders based on the wakalah or hybrid mudarabah wakalah arrangement with the policy holder.

On the other hand, there are no specified agreement among the policy holders in the form of deed or covenant to reflect the mutual trust, goodwill and benefit as evident in economic institutions such as cooperatives. Without polity clarity of intra-policyholder relationships based on mutuality principle of cooperation, trust and benefit such as a trust deed, the lacunae will be assumed by the Takāful Operator discretionary policies.

Given the paradox highlighted in the above section, the attempt to be transparent to policy holders are encumbered by the lack of trust governance mechanism among the policyholders to mandate the takāful operator to execute in the most appropriate, proper and effective manner.

Without such arrangement, most juristic and legal edicts are aligned to the agency relationship between takāful operator and policy holder with implied agency problem and agency related cost consequences on takāful risk fund.

Hence Shari'ah ruling or decision in the interest of policy holder could neither be related nor supported by an underlying arrangement such as trust deed amongst the policy holders. A lacuna of trust fund requirement is assumed in the case of takāful risk fund. Though Takāful risk fund is attributed to policyholders, its status as technical provision did not adequately or sufficiently specify the policyholder rights on the governance and utilization of the fund by the Takāful Operator.

Conclusion and Recommendation

The sanctity of the risk fund and its surplus could be established with a formal trust deed to govern the risk fund and its surplus based on the policyholders' mandate to the Takāful Operator. The deed binds the participants to a common agreement based on principle of mutuality in cooperation (ta'awun), trust (amānah) and benefit (manfa'ah). This is intended to protect and preserve the rights of the policy holders and to safeguard their interest. With the trust deed the policyholders could mutually appoint the Takāful Operator as agent underwrite specific peril that arise from specified hazard.

The choice and variation of the trust deed may enable policy holders to expound on its original purpose of social security as a safety net among the policyholders and contingent claims from incident of peril to prospective investment yield from surplus and social contribution to the community. In this manner the risk fund as a trust fund retain its identity of its social purpose to mee the needs of the stakeholders particularly the policyholders and hence may establish the much-needed stakeholder legitimacy in addition to regulatory soundness and stability as well as commercial viability of the Takāful Operator.

With this product structure innovation, it is hoped to alleviate the scepticism amongst the potential Islamic preference investor and Takāful policy holder community on the coherence and consistency of Takāful as serving a social purpose distinct from the conventional insurance. With greater clarity, transparency and legitimacy of the Takāful trust deed and its provisions, the increasing awareness, acceptance and adoption will enhance the penetration rate of Takāful in the Islamic financial community.

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