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Shari'ah Inspection in Surplus Distribution: *Shari'ah* Views and their Current Implementation

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Abstract

This research aims to shed light on a number of issues related to surplus distribution in takaful. The first part would be devoted to revisiting the main financial concepts related to the surplus, such as the underlying surplus and profit. Modes of distribution, such as pro-rata and offsetting will also be discussed in the light of equity principle advocated by the *Shari'ah*. The second part would deal with the major juristic views and doctrines delineated in favor of surplus distribution. Legal doctrines, such as the ownership or otherwise of the surplus after donation would be meticulously discussed in light of current practices of the takaful operators. The last part would deal with a general outline of *Shari'ah* parameters, in relation to equitable surplus distribution. This is followed by a scrutiny of the surplus distribution practices of modern takaful operators, both in Malaysia and abroad.

Keywords**:** surplus distribution, ownership, equity, *maqasid al-shari'ah,* ratios.

Introduction

Surplus distribution is an important operation in takaful business. Being a *ta'awuni* instrument to provide a mutual guarantee for possible risks, surplus arises as an issue of what to do with it if such risks are dealt with through risk transfer or indemnification. As far as surplus distribution is concerned, two juristic views have surfaced and dominated the takaful industry in the Middle East and Malaysia. The first one categorically prohibits the sharing of the underwriting surplus between the takaful operator and the participants, but the other view validates the sharing, based on ratios that differ according to the line of products

offered. In this research, we tend to re-examine the Islamic principles of surplus distribution, scrutinize the juristic differences on surplus sharing and investigate modern practices of surplus sharing in the light of the general principles and *maqasid al-shari'ah.*

Surplus distribution: revisiting the concepts, modes and the models

A recorded surplus at the end of the financial year of a particular takaful operator is an issue that invokes both *Shari'ah* and legal scrutiny. The views of *Shari'ah* scholars and practitioners on surplus distribution converge and sometimes diverge, depending on the *Shari'ah* and legal framework within which such an issue is addressed. Three issues need scrutiny at this junction: the concepts, the modes and the recent shift from the *mudharabah* to the *wakalah* model.

a. The concepts: profit vs. surplus

The semantic juxtaposition between profit and surplus seems to perplex the very concept of the distributable surplus. The terms profit and surplus are sometimes used interchangeably, but they are technically different, depending on the model adopted by a particular takaful operator. Until recently, the *mudharabah* model adopted by Malaysian takaful operators refer to profit as the underwriting surplus, which is the excess of premiums over claims, plus investment returns.

This arrangement marks a departure from the original *mudharabah* model, which will entitle the takaful operator a ratio in the investment returns, without sharing in the underwriting surplus. The modified *mudharabah* model justified the sharing of the underwriting surplus on the grounds that such an arrangement would allow takaful operators to withstand competition and avoid overpricing, which may eventually sway takaful participants from takaful,[1] and be attracted to

[1] Muhammad Obeidullah, **Islamic Financial services** (Jeddah: Islamic Economics Research Center, King Abdul Aziz University, n.d), p.133.

conventional insurance, with all its non-*Shari'ah* compliant elements. This is further justified by the fact that there is nothing *haram* in sharing the underwriting surplus, in the view of the absence of any textual or general *Shari'ah* principle disapproving such a practice. The thrust of this argument will be discussed later in this research.

On the other hand, the *wakalah* model provides for yet another avenue to practice takaful on a more *Shari'ah*-compliant frame work. Widely practiced in the Middle East, the *wakalah* model clearly spells out the difference between underwriting, which is the excess of premiums over claims, and investment returns through investing the *tabarru'* fund. While the profits, being the investment returns, are allowed to be shared on a pre- defined ratio basis, the underwriting surplus is not to be shared, and shall go back to the participants at the end of financial year, or be used to established new reserves[2] or even lowering prices for subsequent underwriting years. The AAOFI Standard on takaful reads:

5/5 *It is permissible for the policy to contain a provision to deal with the underwriting surplus according to maslahah, as stated in the terms of the policy, such as the establishment of reserves, the reduction of prices, donating to charities, or distributing it or a part thereof to the participants, provided the Takaful operator does not share in it.*[3]

The AAOFI standard can be seen as a counter argument to the Malaysian approach, a matter which will be addressed later in the research.

b. Modes of surplus distribution

There are three major modes of surplus distribution adopted by takaful operators:

1. **Pro-rata mode**: Whether the surplus is underwriting surplus plus profit or underwriting surplus only, it is distributed in proportion to the

[2] See Wahbah al-Zuhayli, **al-Mu'amalat al-Maliyyah al-Mu'asirah** (Damascus: Dar al-Fikr, 2002), p.278.
[3] Hai'at al-Muhasabah wal muraqabah al-Shari'iyyah li al-Mu'assasat al-Maliyyah al-Islamiyyah, (AAOFI), (Manama: AAOFI, 4-5), p.437.

premium paid by the participants, without differentiating between claimable and non-claimable accounts. This mode seems to be in line with the objective of *takaful ta'awuni*, which is to provide mutual guarantee and reciprocal risk protection.[4] An example of this would be Sharikat al-Barakah for Islamic Insurance in Sudan[5];

2. **Selective mode**: This mode tends to indemnify non-claimable accounts only. Takaful operators tend to deprive claimable accounts, so that they become more prudent in the future. The surplus is distributed as an incentive to the participants, which is a kind of involving them into the process of risk selection and adequate underwriting for a given financial year. An example of this mode would be the Islamic Insurance Company in Qatar. Again, this selection has a bearing on the *Shari'ah* principle that considers the underwriting surplus the "property" (*milk*) of the participants, the very point that we will use later to discuss the ownership element claimed on the underwriting surplus;
3. **0ff-setting mode**: This mode tends to offset the rate of underwriting surplus from the amount claimed. This is applicable only on accounts whose underwriting surplus less than the claims. If the underwriting surplus is equal or more than the claims, then the participant does not share in the surplus. This mode is viewed as the most equitable amongst the other modes. It is more accurate in terms of calculation, and more so in terms of justice and *ta'awun* (operation).[6] This mode has been adopted by some takaful companies, such as the Islamic Insurance Company of Jordan. The latter determines the percentage of surplus distribution for each participant, as follows:

Distributable surplus

[4] Ali Muhyiddin al-Qurgaghi, **Al-Ta'min al-Islami** (Beirut: Dar al-Basha'ir al-Islamiyyah," 2006), p.311. See also Fatawa al-Tamin, complied and edited by Dr.abdussatar Abu-Guddah and Dr. 'Izzuddin Khojah (Dallah al-Barrkah).
[5] Ahmad Salim Milhim, **Al- Ta'min al- Islami**, (Daral al-I'lam: Amman, 2002), p.167
[6] See Fatawa at-Ta'min, p.185; Milhim, al-Ta'min al-Islami, p.168.

% of surplus distribution = $\dfrac{\qquad\qquad}{\text{Positive account for each participant}}$

As for the share for each participant, it follows the following formula:

Share = Positive account X % of surplus distribution

The above mentioned modes are all *Shari'ah*-compliant, based on the principles of *maslahah* and *urf,* which would make it up to the practitioners to opt for any mode that best serve the industry. These modes are *Shari'ah*-compliant, whether they are considered in one line of product or in the overall lines of products.

In Malaysia, a typical *wakalah* mode adopts the following formula:

$$st = EEC - \sum_{1}^{12} NCI_{T-12} - \sum_{1}^{12} WF_{T-12} + \sum_{1}^{12} NII_{T-12}$$

EEC $_t$ = Expected earned contributions from all policies in force as at time t.

$$= \sum_{1}^{12} GC_{t-12} - \sum_{1}^{12} NRI_{t-12} - UCR_t - \mathrm{Pr}\,ovision\ for\ bad\ debt$$

where,

$\sum_{1}^{12} GC_{t-12} =$ = Sum of contributions for all in-force policies incepted during the last 12 months

$\sum_{1}^{12} NRI_{t-12}$ = sum of retakaful contributions paid (net off reinsurance commission, if any) during the last months.

UCR_t = UCR for all in-force policies as at time t

Provision for bad debt is 1 month for motor policies and 6 months for other types of policy.

$\sum_{1}^{12} NCI_{t-12}$ = sum of net claims incurred during the last 12 months (Inclusive of IRNR, outstanding claims and claims paid)

$\sum_{1}^{12} WF_{t-12}$ = Sum of *wakalah* fees due from all policies incepted during the last 12 months

$\sum_{1}^{12} NII$ = Sum of net investment income arising from all policies incepted during the last 12 months

(Investment income is to be calculated on a monthly basis and income declared for the year should be properly weighted for each month).

c. From modified mudharabah to modified wakalah.

Most takaful operators in Malaysia have now adopted the *wakalah* model after applying the *mudharabah* model for more than two decades. The latter model underwent a transformation, where the takaful operator only shares in the investment returns, to modified *mudharabah,* where both the underwriting surplus and investment returns are shared between the takaful operators and the

participants. Very recently, the same takaful operators have adopted the *wakalah* model, but only after a modification that would entitle the takaful operator a share in the underwriting surplus. This modified *wakalah* model is a departure from the pure *wakalah* model practised in the Gulf and the Middle East, whose main feature is the impermissibility for takaful operators to share in the underwriting surplus. The shift would yield three returns to the takaful operators, as authorized by Bank Negara Malaysia:

- upfront fees (i.e.: *wakalah* fee);
- Profit from participants' fund; and
- Surplus on investment profit from Risk Fund.[7]

There are definitely actuarial differences between the modified *mudharabah* model and the modified *wakalah* model. The shift to the new model may be triggered by the rapid development in the takaful and retakaful industry that would sometimes necessitate the diversification of models. Besides, issues pertaining to pricing and incentives do have an impact on the diversity of models. Prices could be lowered in a modified *wakalah* model as the lowered portion could be recovered from surplus sharing. Thus, if the shift would lead to more competitive prices, and the whole operational framework would be more *ta'awun* (cooperative) than commercial, then the modified *wakalah* model will be hailed as a positive development in the takaful industry. Conversely, if the shift would eventually add another source of return to the shareholders, i.e. *wakalah* fee at the expense of the participants, especially when they get a very low percentage of the underwriting surplus, then the whole idea *of ta'amin ta'awuni* would be at stake, especially when prices are not reduced or the participants are asked to top up the risk fund to cover deficits. By then, the shift to the new model would be suspiciously viewed as an attempt to earn more through spreading the earnings in three layers (*wakalah* fee, investment returns and underwriting surplus)

[7] Takaful Operational Framework, Bank Negara Malaysia, p.9.

instead of two, as practised in the *mudharabah* model (i.e investment returns and underwriting surplus).

Islamic principles of surplus distribution

The main controversial issue between Middle East Islamic insurance companies and most Malaysian takaful operators is the sharing of the underwriting surplus. The opponents of sharing the underwriting surplus back their contention by decisions taken by highly acclaimed institutions, such as AAOIFI, whose standard on takaful reads: "The Takaful operator does not share in the (underwriting surplus)".[8] A few major reasons are given to deny the Takaful operator a share of the underwriting surplus:

The under underwriting surplus belongs exclusively to the participants

The AAIOFI Standard on takaful states: "The underwriting surplus and its returns, less expenses, and payment of claims, remain the property **(*milk*)** of the policyholders, which is the distributable surplus. This is not applied in commercial insurance, where the premiums become the property of the (insurance) company, by virtue of contract and acquisition, which would make it revenue and a profit for commercial insurance".[9]

This assertion by AAOIFI would lead us to raise the issue of ownership claimed on the premium paid. On the one hand, the participant has donated the premium as *tabarru'*, hence, losing title over it, as prescribed by the rules of *hibah* in the *Shari'ah*, but on the other hand, he still holds claim over it in the form of getting the whole underwriting surplus or a part thereof[10]. This requires a juristic scrutiny that investigates the ownership element in *hibah* and the extent of its *Shari'ah* compliance in the takaful industry.

[8] AAOFI Standard on Takaful, p.437

[9] AAOIFI Standards, p.446.

[10] Mohd. Ma'sum Billah, **Islamic and Modern Insurance** (Selangor: Ilmiah publishers, 2003), p.302.

There are a number of jurists who emphasized that pure *hibah* leads the *wahib* to relinquish his ownership over the object of *hibah*. Ibn Qudamah asserts that "*al-hibah tamalik*"[11] (*hibah* requires the *wahib* to enable the beneficiary to claim title of the object of *hibah)*. Al Imam al- Shirazi points out that "*Al-hibah tamlik bighayri 'iwadd* "[12] (*hibah* is enabling the beneficiary to own the object of *hibah* without an exchange). In such a case, the juristic implications of *hibah*, as Ibn Nujaym al- Hanafi asserts, will be the transfer of *hibah* to the beneficiary, entitling him to hold title over the object of *hibah* (*thubut al-Milk lil mawhubi lahu*).[13]

Generally speaking, the Shafi'is view *hibah* as transferring the ownership of an asset without exchange during one's lifetime, on a voluntary basis.[14] The other *mazahib* (schools of jurisprudence) refer to the same meaning, with a special emphasis on the element of "no exchange", i.e.: *bi ghayri 'Iwadd*.[15] This transfer of ownership would be effective, either by way of acquisition (*qabd*) on the part of the beneficiary, which is the view of the Shafi'is[16] and Hanafis,[17] or by way of *ijab* and *qabul* (offer and acceptance),, which is the view of the Malikis.[18]

This juristic approach is an evidence that *tabarru'* requires the relinquishing of ownership over the object of *hibah*. Since the latter entitles *tamlik* to the beneficiary, we can rightly say that the *mutabarri'* (donor) does not hold any legal right or claim over the asset donated. Having said so, the takaful operators are at liberty to stipulate conditions on how the underwriting surplus should be distributed, invoking the doctrine of *shurut* (conditions) in contracts, as articulated in Islamic jurisprudence. The only shroud of right that the donor may still enjoy to hold title of his *hibah* is when he donates it in exchange for a countervalue, a principle known as "*hibah al-thawab*", which will be highlighted in the next point.

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[11] Ibn Qudamah al-Hanbali, **Al-Mughni**, (Beirut: Dar al-Fikr, H1405), 9/418.

[12] Al-Shirazi, **al-Muhadhab fi fiqh al-Imam al-Shafi'I** (Beirut: Dar al-Fikr, n.d.), 2/127. See also Al-Shirbini, **Mughni al-Muhtaj** (Beirut: Dar al-Fikr, n.d), 2/397.

[13] Ibn Nujaym, **Al-Bahr al-Ra'iq Sharh Kanz al- Daqa'iq** (Beirut: Dar al-Ma'rifah, n.d.), 7/284.

[14] Al-Qalyubi wa Amirah, **Hashiyat Al-Qalyubi wa Amirah** (India: al-Dar al-Salafiyyah, n.d.), 3/110.

[15] See Mohd Almash, **Minah la-Jalil Sharh Mukhtasar Khalil** (Beirut: Dar al-Fikr, 1984), 4/82.

[16] Al-Shirbini, **Mughni al-Muhtaj Sharh al-Minhaj** (Cairo: Matba'at al-Babi al-Halabi, 1958), 2/123.

[17] Al-Kasani, **Bada'I' al-Sana'I'I** (Beirut: Dar al-kitabal Arabi, 1982), 6/123.

[18] Ibn Rushd, **Bidayat al-Mujtahid** (Beirut: Dar al-Kutub al-Ilmiyyah, 1988), 2/329.

1. ***Hibat al-thawab* as grounds for surplus distribution exclusively to the participants**:

Contemporary scholars like al-Qurdaghi are of the view that the principle of *hibat al-thawab* (a gift for on exchange) is a good premise to justify the confinement of surplus to the participants only.[19]This contention can be challenged in many ways:

a. All the Prophetic hadiths substantiating *hibat al-thawab* are based on the contrast between *hibah* (gift) from one side and *thawab* (exchange) from the other, ie: total *hibah* for total *thawab*. Imam Sana'ani would refer to the hadith of "Aisha (R.A) who said: The Prophet (s.a.w) used to accept *haddiyyah* (gift) and reward its giver (Bukhari)".[20] Hence, looking at the underwriting surplus, I would not understand it as the *thawab* referred to in the aforementioned hadith. The underwriting surplus is simply a part of the initial *hibah*, for which a *thawab* is sought. Thus, the *thawab* should be something different from the *hibah* and not a part thereof;

b. It is true that some of the Prophetic hadiths referring to *hibat al-thawab* have secured some right of ownership to the donors after donation. Ibn Qayyim addressed the issue by approaching some hadiths that are apparently in conflict. On the one hand, the hadith of

"العائد في هبته كالعائد في قيئه"[21]

(He who retracts his *hibah* is like the one who swallows what he vomits), would make it *haram* to retract the gift on whatever grounds the retraction is made. This means that the donor has lost title of the *hibah* and cannot benefit from it again. On the other hand, there are a few hadiths that

[19] Al-Qurdaghi**, al-Ta'min al- Islami,** p.311.
[20] Al-San'ani, **Subul al-Salam** (Beirut: Dar al-Ihya' al-Turath, H1379), 3/91.
[21] Abu Daud, **Sunan Abi Daud** (Beirut: Dar al-Fikr, n.d.),3/231.

secure some right of ownership of the *hibah* by the donor, even after donating it. Ibn Qayyim mentions the following hadith:[22]

عن أبي هريرة رضي الله عنه قال: قال رسول الله صلى الله عليه وسلم:

"الواهب أحق بهبته ما لم يثب"

"Abu Hurairah narrated that the Prophet (s.a.w.) said: "The donor holds an exclusive right of ownership over his *hibah,* provided he is not rewarded for it". This hadith is the only piece evidence attesting to a conditional ownership of the *hibah* by the *wahib*, allowing him to retract his *hibah* if he is not rewarded or satisfied with the reward. However, as clearly understood from the hadith, this evidence only gives conditional retraction of the same gift, **not a surplus of it**. In the case of Islamic insurance (takaful), this hadith is not applicable to surplus distribution, rather it is about retraction of *hibah.* Hence, it does not stand as an evidence of the *wahib*'s ownership of *hibah* after donating it to the takaful fund. For the sake of objectivity, I do not claim that the proponents of the "ownership theory" have used this hadith to substantiate their view, but I do believe that even when they tend to adduce it in support of their contention, by virtue of being the most reliable hadith in reference to the "theory of ownership" of *hibah*, it would not stand as a conclusive evidence for the issue at hand.

The apparent conflict between the two aforementioned hadiths can be dealt with in a way that both can be implemented according to their specific contexts. Despite the weak status of hadith of Abu Hurairah, stated earlier, as mentioned by Ibn Jawziyyah,[23]Ibn Qayyim would consider both hadiths valid, by predicating the hadith of the prohibition of retracting *hibah* on the *wahib* who has given a pure *hibah*, without seeking *thawab*, while the hadith of the permissibility of retraction is predicated on

[22] Ibn Qayyim al-Jawziyyah**, I'lam al-Muwaqi'in** (Beirut: Dar al-Jil, 1973), 2/335
[23] See al-Shawkani, **Nayl al-Awtar** (Beirut: Dar al-Jil, 1973), 6/115

the premise that the *wahib* has stipulated a *hibah*, of which he is denied or is unsatisfied with the *thawab*.[24]

2. The hadith of *Nahd* as grounds for surplus distribution to go exclusively to the participants

It has been held that the hadith of Nahd/Nihd is also a good premise for confining the surplus distribution to the participants only. Al-Bukhari states in his Sahih (Book of Sharikah) that "Muslims did not see any harm in *Nahd*"[25]. The latter, as Ibn Hajar explains, is "The allocation of a fund in proportion to the number of participants (in the fund)"[26]. Although this arrangement was more useful and practical in journeys to provide mutual coverage of expenses, it has been viewed as a mechanism to transfer risks, whether in a journey or otherwise.
After citing the same hadith, the appendix of AAOIFI Standard on Takaful provides an explanation to Ibn Hajar's definition of *Nahd*. The Standard states that Ibn Hajar's definition of *Nahd* refers to the underwriting surplus, which should be redistributed to the participants, so that it could be used in another journey.[27]
Revising Ibn Hajar's view in his Fath al-Bari, we can hardly understand what AAOIFI experts have understood. Ibn Hajar's definition and explanation of *Nahd* does not refer in any way to surplus redistribution to the same participants. The hadith, is thus, completely silent about surplus, opening the doors for *ijtihad* to be exercised, in view of the *maqasid al-shari'ah* and general Islamic financial principles.

3. **Sharing in the underwriting surplus is a kind of taking peoples' property unjustly**

[24] Ibn Qayyim al-Jawziyyah, **I'lam al-Muwaqi'in**, 2/335.
[25] Bukhari, **Sahih Bukhari**, ed. Mustapha Dib al-Bugha (Dar Ibn Kathir, 1987), 2/879.
[26] Ibn Hajar al- 'Asqalani, **Fath al-Bari Sharh Sahih al- Bukhari** e.d. Muhibuddin Al-Khatib (Beirut: Dar al-Ma'rifah, n.d), 5/129
[27] AAOIFI Standards, p.447.

This contention is held by prominent scholars like Hussein Hamid Hassan[28] and Al-Qurgaghi.[29] The contention seems to go beyond the accepted parameters of justice. Although there could be plausible grounds for such a view, in light of the practices of some takaful operators that seize the lion's share of the underwriting surplus, there should not be any shred of doubt that, in light of our earlier juristic analysis, sharing the underwriting surplus is *Shari'ah*-compliant as long as it falls within the parameters of accepted conditions (*shurut*), as well as the principle of the *rida* (satisfaction), featuring such contracts. With the existence of sound regulatory framework that caps the percentage of the distributable surplus, takaful operators will not be in a position to take people's property unjustly, nor do I believe that there exists any takaful operator which is inclined to do so. Acknowledging the fact that the surplus of the Risk Fund belongs exclusively to the pool of participants, Bank Negara Malaysia allows in its unofficial guidelines for all takaful operators to share in the surplus of the Risk Fund, based on a capped ceiling and types of products,[30]a point which will be highlighted in the next item.

Equitable vs. arbitrary surplus distribution

A crucial issue arises as to whether current surplus distribution is equitable or arbitrary. We would address this issue on the premise that surplus distribution is permitted by the *Shari'ah*, in view of our earlier juristic argument. There is more than one practice of surplus distribution in takaful business, and one can only afford to be selective for the sake of brevity and clarity. But before I embark upon unveiling some experiences, I would like to lay emphasis on the concept of equity in surplus distribution. From the *Shari'ah* perspective, the whole issue of takaful, including the issue of surplus distribution ratios, is an *ijtihadi* matter that would depend on *maslahah* and *'urf* (custom) to put it into practice. Actuarial input is

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[28] Hussein Hamid Hassan, **Usus al- Takaful al-Ta'mini fi daw' al-Shariah al-Islamiyyah**, a paper presented 0f the 1st International Takaful seminar in Saudi Arabia, 21st September 2004, p.20.
[29] Al- Qurgaghi, **al-Ta'min al-Islami**, p.310.
[30] Takaful Operational Framework, Bank Negara Malaysia, 2006 an unofficial set of guidelines purported to be enforced.

equally important to determine the ratios, to the extent that the surplus, on the recommendation of the Actuary, may not even be distributed to boost the reserves instead. Since the underwriting surplus belongs neither to the takaful operator nor to the participant, as we argued in this research, the following parameters of equitable surplus distributions are proposed:

1. The ratio of surplus distribution is to be decided by both the takaful operators and the participants or their representatives in the administrative board. Many contemporary scholars have insisted that the participants must be represented in the administrative board, on the grounds that the Risk Fund belongs to them[31]. Their presence may curtail some takaful operators when they tend to adopt an arbitrary ratio;
2. Equity in *maslahah* rather than equity in numerical ratios. The ratio may not necessarily have a numerical equivalence such 50:50 to have an equitable surplus distribution. The *maslahah* and '*urf* and '*adalah* (justice) must be the main *Shari'ah* principles that help determine such ratios. Thus, a 60:40 ratio could be pretty equitable if it meets these *Shari'ah* principles; and
3. It is permissible to adopt different surplus distribution ratios according to different lines of products.

For a practical example, we shall now select one example from overseas Islamic insurance companies and a few examples from the Malaysia scene.

a. The overseas experience:

One of the leading Islamic insurance company in the Gulf is the one under Bank Aljazira in Saudi Arabia. Adopting the *wakalah* model, the company is compensated via agency fees in the form of:

a. percentage of contribution: this percentage covers:

[31] See Shubair, **al-Mu'amalat al-Maliyyah al-Mu'asirah**, pp.155-158

- The operating cost of Bank Aljazira in running the takaful programme;
- A performance related commission: This is the underwriting surplus, which is defined as the excess of contributions over claims. This fee is regarded as an incentive to:
    - Ensure prudent underwriting;
    - Optimize investment performance of the takaful funds;
    - Minimize direct expenses related to the takaful fund, such as issuance cost, stamp duty, legal fees, reinsurance cost, etc; and
    - Monitor fraudulent claims.[32]

The Saudi Arabia monetary authority has approved 10% of underwriting surplus to be redistributed to the participants and 90% to the shareholders.[33] I am of the view that this is an arbitrary surplus redistribution, which has gone beyond the element of incentives. The continuation of the practice may defeat the whole purpose of takaful and it is highly likely that the takaful industry would turn into a profit seeking operation. The unfairness is even bitter when the participants are not involved in determining the ratio of surplus distribution. Even though some scholars may argue that this arrangement could be predicated on ‘*uqud al-Id’han* (contract of subjections), whereby one of the contracting parties would accept the contract even though he may disagree with one or some of its terms, the ratio 10:90 is clearly arbitrary and may cast doubt over its *Shari’ah* compliance, in view of the proposed parameters of equitable surplus distribution.

b. The Malaysian experience:

The Malaysia experience in takaful has witnessed two phases: The first one was when the Takaful Act 1984 legalized the modified *mudharabah* model, whereby profit, defined as underwriting surplus + investment returns, could be shared

[32] See: www.baj,com.sa

[33] www.sama.gov.sa/ar/insurance . See also Dr. Mohd. Liba, **al-Ta’min al-Ta’awuni wa tatbiqatuhu fi Bank al-Jazirah wa Shrikat Ikhlas lil Takaful bi Malaysia**, a PhD Dissertation, 2006, p.249.

between the takaful operator and the participants, based on a ratio agreed upfront. The ratio for MNI Takaful use 20:80 and 30:70 for Takaful Malaysia, meaning that 20% for MNI Takaful and 30% for Takaful Malaysia are credited to the shareholders' fund.[34] The second phase is when all Malaysian takaful operators recently shifted to the *wakalah* model, except for Takaful Malaysia, which is still applying the *mudharabah* model.

Malaysian takaful operators have recently adopted a modified *wakalah* model, which would allow them to earn from *wakalah* fee, investment returns from the participants fund and a share from the underwriting surplus. Bank Negara Malaysia, in its yet enforceable guidelines, has set limits for surplus/profit sharing, which are as follows:

- Products with savings elements
  - Maximum 30% of the investment profit; or
  - Maximum 10% of surplus.
- Product with protection purpose
  - Maximum 50% of surplus; and
  - Additional 10% of surplus for takaful operators, without upfront fees.
- Product with protection and savings element
  - Weightage of the above.[35]

There are different ratios of surplus distribution applied by Malaysian takaful operators, based on different *Shari'ah* principles followed.

Takaful Malaysia, the only company applying the *mudharabah* model, distributes the surplus on 70:30 ratio for family takaful, [36] and 60:40 for general takaful. One question may be eminent as this juncture: Do proponents of this model share in

[34] See Mohd Obaidullah, Islamic Financial Series, p.136 (Prof Obeidullah relied on information provided by www.takaful-malaysia.com and www.takaful.com at the time he wrote his book). The same information is still available on the same sites at the time of writing this article, with an addition of a clarification related to 70:30 ratio whereby this ratio is for family Takaful, and 60:40 for general Takaful).
[35] Takaful operational frame work, 2006, Bank Negara. P.13.
[36] See previous footnote. As of October 2008, the company announced a 15%. Mudarabah surplus from the participants net contributions.

the underwriting loss besides sharing in the underwriting surplus? Muhammad Ayub noted that "the takaful operator (adopting this *mudharabah* model) gets the underwriting surplus, but does not bear the underwriting loss"[37]. Although this is not true, the system may still be confusing and problematic, in view of the current practice of combining the profits of investments and the underwriting surplus in one pool. Another problem with the model would be the capacity with which the participant would sign the takaful contract with the takaful operator. Upon signing the contract, the participant is acting both as *mutabari'* and *rabb al-Mal* (capital provider). This would pose a *Shari'ah* problem, given the simultaneity that both capacities are in force. This means that the same amount of money is given as *tabarru'* and capital at the same time. This is not possible, as both have their distinct legal implications and may lead to disputes.[38]

The other problem is that the participants are not really involved in determining the ratios of surplus distribution, despite Bank Negara's assertion that the "Surplus of the Risk Fund belongs exclusively to the pool of participants, and that the takaful operators are allowed to share the surplus or investment profit, based on the contract between the participants and the takaful operator"[39]. Even though we have argued earlier that the underwriting surplus belongs neither to the participants nor to the takaful operators, both parties should be involved in determining the ratios and mechanisms of dealing with surplus. A practical way is for the takaful operator to dispose off the surplus as he deems fit, subject to the prior agreement of the participants.[40]

Another manifestation of equitable distribution would be the allocation of surplus to the policyholders by means of reversionary bonuses[41], every one, two or three years, the percentage of which would be decided by the actuarist of the takaful

[37] Muhammad Ayub, **Understanding Islamic Finance** (London: John Wiley, 2007), p.424.
[38] See my presentation on **Critical issues in Takaful and Re Takaful**, a paper presented at the International Summit on Mu'amalat, 28th-29, 2008 Jakarta, Indonesia.
[39] Takaful Operational Framework, 2006, Bank Negara Malaysia. p.12.
[40] Zainal Abidin Mohd. Kassim, **Takaful: Islamic Insurance in Malaysia**, in *Islamic Retail Banking and Finance: Global Challenges and opportunities*, e.d. Sohail Jaffer (n.p: Euromoney Books, 2005), p.126.
[41] Mohammad Ariff, The Muslim Private Sector in South East Asia: Islam and the Economic Development of South East Asia (n.p: Institute of South East Asia Studies, 1991), p.209.

operator. The non- claim bonus (NCB) practised by takaful operators is an example.

Takaful Ikhlas is another takaful operator that is entrenching itself in the Malaysian takaful market. As far as surplus is concerned, the company states the following in its family takaful certificate:

> *All contributions made under this supplementary Certificate will be allocated into participant Risk Investment Account (PRIA). For any investment income derived from the PRIA, the company will charge a performance fee of* ***10%.*** *The resulting net investment income will be allocated in full to the participant. The participant will also be entitled to a net surplus from the Risk Fund after the deduction of surplus administration charge arising every month*[42]*.*

The 10% percent charged to the underwriting surplus is justified on the following *Shari'ah* bases:

- The 10% is an incentive fee, based on the contract of *ju'alah* (performance fee);
- The verse in Surah an-Nisa' verse 29, which considers *rida* (satisfaction) as one of the basis of a valid contract;
- The hadith: "Muslims are bound by the conditions they stipulate to each other, except when those conditions prohibit what is permissible, or permit what is prohibited (Bukhari).

  المسلمون على شروطهم إلا شرطا حرم حلالا أو أحل حراما (البخاري)
- The Islamic legal maxim: "The original *Shari'ah* status of things is permissibility".

I would say that the *ju'alah* contract fits the arrangement chosen by Takaful Ikhlas, as long as the fee charged is from the surplus, which may or may not exist at the end of the financial year. This is in line with the concept of *ju'alah*,

[42] Ikhlas Family Takaful Certificate, p.21

which is the "payment of a reward for the uncertain fulfillment of a work".[43] While there is no *Shari'ah* problem with the 10% performance fee, a *Shari'ah* concern may arise, as to the term "surplus administration charge" deducted from the Risk Fund in favor of Takaful Ikhlas. Dallah al-Barakah's Shari'ah Committee would disagree with charging administration fee from the underwriting surplus. It maintains that the administration fees must be known and paid upfront, regardless of whether there is surplus or not.[44]

On the other hand, another takaful operator, HSBC Amanah Takaful takes 80% from the Risk Fund as an incentive, while 20% will be reserved for distribution amongst eligible participants.[45] The surplus distribution is based on pro-rata, based on the contributions during the financial year, if it is more than RM10. My view is that the 80% is quite high and a revision of this ratio would be more in line with the nature and objective of takaful, let alone equitable distribution.

Opposite to HSBC Amanah Takaful is Etiqa, which is adopting a 80:20[46] ratio for family takaful, i.e. 80% to the participant and 20% to Etiqa. As for general takaful, a ratio of 50:50 is adopted, which seems quite equitable and in line with Bank Negara's guidelines. The paragraph on surplus sharing reads:

> *We will receive 50% of the surplus as incentive for being responsible in operating and managing the fund. The balance will be reserved for distribution amongst participants, subject to the provisions of the takaful certificate. The surplus will not be payable if the participant have made claims under his certificate.*[47]

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[43] Al-Shirbini, **Al-Iqna**' (Beirut: Dar al-Fikr, 1977), 2/353.
[44] Fatawa al-Hay'ah al-Shar'iyyah lil Barakah, compiled and annotated by Abd Sattar Abu Ghuddah and Izzuddin Khojah, Dallah al-Barakah, 1997, p.205.
[45] See www.takaful.hsbcamanah.com.my
[46] An interview with Dr.Zulkifli Zakaria, Vice President and Head of Shari'ah Department, EtiQa. He pointed out that for equity purposes, Etiqa's goal is to move from the 80:20 ratio to 50:50 ratio for family Takaful.
[47] Takaful Contract (Etiqa), p.12

I would consider these ratios as more equitable, provided that the concept of incentive should not become an integral part of the contract. The *wakalah* fee is supposed to provide such an incentive, if accurately calculated in proportion of the underwriting expenses.

Conclusion

Two important conclusions are eminent. The first one relates to the right of both the takaful operator and the participant to share in the surplus. Since the latter belongs to neither, both are at liberty to decide on the best way to dispose of it, including its redistribution on an agreeable ratio and in the light of the *maqasid* and the principles of the *Shari'ah*. Whatever ratio proposed, it must be approved by the Shari'ah Advisory Committee of the takaful operator. The second conclusion emphasizes the importance of formulating adequate *Shari'ah* parameters for equitable surplus redistribution. We have made an attempt to shed some light on these parameters, but further *ijtihad* is needed to come up with sound and practical parameters that would enhance the takaful industry, both locally and abroad. By and large, some takaful operators are adopting equitable ratios of surplus distribution, but others still need to revise their ratios, not only to satisfy the dictates of takaful, but also to remain competitive in the market.

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