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SHARĪᶜAH INSPECTION OF SURPLUS DISTRIBUTION IN *TAKĀFUL* OPERATIONS*

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ABSTRACT

This research intends to shed light on a number of issues related to surplus distribution in *takāful*. The first part is devoted to revisiting the main financial concepts related to the surplus such as the underwriting surplus and profit. Modes of distribution such as pro-rata and offsetting will also be discussed in the light of equity principle advocated by *Sharīᶜah*. The second part deals 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 and reviewed in the light of current practices of *takāful* operators. The last part deals with a general outline of *Sharīᶜah* parameters in relation to equitable surplus distribution. This is followed by a scrutiny of surplus distribution practices of some modern *takāful* operators both in Malaysia and abroad. The research argues that while it is strongly recommended to redistribute the surplus to the participants only, there is a considerable *Sharīᶜah* ground allowing *takāful* operators to share in the surplus for reasons outlined in this research.

JEL Classification: G22, Z12

Key words: *Takāful*, Surplus distribution, Islamic finance, Malaysia

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1. INTRODUCTION

Surplus distribution is an important operation in *takāful* business. Being a cooperative instrument to provide mutual guarantee for possible risks, surplus arises as an issue of what to do with it if such risks are dealt with through risk sharing or indemnification. As far as surplus distribution is concerned, two juristic views have surfaced and dominated the *takāful* industry in the Middle East and Malaysia. The first one categorically prohibits the sharing of the underwriting surplus between the *takāful* operator and the participants, which is the view of the majority of scholars as well as Accounting and Auditing Organization for Islamic Financial Intuitions (AAOIFI), whereas the other view, which is championed by *Sharīcah* Advisory Council of Bank Negara Malaysia (Central bank of Malaysia), validates the sharing of surplus 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 the objectives *Sharīcah*.

2. SURPLUS DISTRIBUTION: CONCEPTS, MODES AND THE MODELS

The realization of *takāful* surplus at the end of the financial year is an issue that invokes both *Sharīcah* and legal scrutiny. *Sharīcah* scholars as well a practitioners' views on surplus converge and sometimes diverge depending on the *Sharīcah* and legal framework within which such an issue is addressed. Three issues need scrutiny at this junction: the concepts, the modes, and the shift from *muḍārabah* to *wakālah* model.

2.1 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 *takāful* operator. Until recently, *takāful* operators in Malaysia adopting the *muḍārabah* model treated profit as the underwriting surplus, which is the excess of premiums over claims plus investment returns. This arrangement marks a departure from the original *muḍārabah* model, which would entitle the *takāful* operator a ratio in the investment returns only, without sharing in the underwriting surplus. The modified *muḍārabah* model justifies the sharing of the underwriting surplus on the ground that such an arrangement would allow *takāful* operators to withstand competition and avoid overpricing, which may lead *takāful* participants to switch to conventional insurance (Obeidullah, n.d.). This is further justified by the fact that arguably there is sufficient *Sharīᶜah* ground to share in the underwriting surplus, especially in the absence of any textual or general *Sharīᶜah* principle disapproving such a practice, which is the main contention of this research. Besides, the *Sharīᶜah* Advisory Council of Bank Negara Malaysia permits both *takāful* operators and participants to share in the underwriting surplus on the ground of the *tabarruᶜ* nature of the *takāful* operation.[1] Another argument holds that Middle Eastern *takāful* companies are allowed by their *Sharīᶜah* boards to charge a performance fee from the surplus, though with some conditions namely, the *takāful* operator is entitled to the performance fee if there is surplus, (Adawiah and Scott, 2008; Arbouna, 2008 and al-Tijani, 2010). The thrust of this argument will be discussed later in this research.

On the other hand, the *wakālah* model provides for yet another avenue to practice *takāful* on a more *Sharīᶜah*-compliant framework. Widely practiced in the Middle East, the pure *wakālah* model clearly spells out the difference between the underwriting surplus, which is the excess of premiums over claims, and investment returns realized from investing the *tabarruᶜ* fund using the *muḍārabah* instrument.[2] While the profits, being the investment returns, are allowed to be shared on profit sharing basis, the underwriting surplus shall be re-distributed to the participants, or be used to establish new reserves or lower future prices for subsequent underwriting years (al-Zuhayli, 2002). Paragraph 5/5 of AAOIFI Standards on *takāful* reads:

> It is permissible for the policy to contain a provision that deals with the underwriting surplus according to *maṣlaḥah*, as stated in the terms of the policy, such as the establishment of reserves, the reduction of prices, donating (the underwriting surplus) to charities, or distributing it or a part

thereof to the participants, provided the *takāful* operator does not share in It (AAOIFI, 2008).

The AAOIFI Standards can be seen as a counter argument to the Malaysia approach, a matter which will be addressed later in the research.

2.2 MODES OF SURPLUS DISTRIBUTION

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

i. Pro-rata mode: whether the surplus is treated as underwriting surplus plus profit or underwriting surplus only, it is distributed in proportion to the premium paid by the participants, without differentiating between claimable and non-claimable accounts. This mode seems to be in line with the objective of *takāful ta^cāwuni*, which is to provide mutual guarantee and reciprocal risk protection (Qurdaghi, 2006; Abu-Guddah and Khojah, n.d.). An example of this would be Sharikat al-Barakah for Islamic Insurance in Sudan (Milhim, 2002).

ii. Selective mode: this mode tends to indemnify non-claimable accounts only. *Takāful* operators tend to deprive claimable accounts so that they become more prudent in protecting their insured assets in the future. An example of this mode would be Islamic Insurance Company in Qatar (Qurdaghi , 2006) Again this selection has a bearing on the *Sharī^cah* 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.

iii. Offsetting mode: this mode tends to offset the rate of underwriting surplus from the amount claimed. This is applicable only on accounts whose underwriting surplus is 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^cāwun* (cooperation), (Abu-Guddah and

Khojah, n.d.).This mode has been adopted by some *takāful* companies such as Islamic Insurance Company of Jordan (Milhim, 2002). However, in case the participant surrenders his policy before the distribution of surplus, he would lose his entitlement to the surplus as he would no more be a participant in the pool (Nashmi, 2010).

The abovementioned modes are all *Sharīᶜah*-compliant based on the principles of *maṣlaḥah* and '*urf* which would leave it up to the practitioners to opt for any mode that serves the *takāful* industry best. These modes are *Sharīᶜah* compliant whether they are considered in one line of product or in multi lines of products.

In Malaysia, a typical *wakālah* model adopts the following formula:

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

(2) $EEC_t = \sum_{1}^{12} GC_{t-12} - \sum_{1}^{12} NRI_{t-12} - UCR_t -$ Provision for bad debt

where,

EEC_t is expected earned contributions from all policies in force at time *t*,

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

$\sum_{1}^{12} NRI_{t-12}$ is sum of re*takāful* contributions paid (net of *RI* commission, if any) during the last months.

UCR_t is *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 policy types.)

$\sum_{1}^{12} NCI_{t-12}$ is sum of net claims incurred during the last 12 months, (Inclusive of *IRNR*, O/S claims and claims paid)

$\sum_{1}^{12} WF_{t-12}$ is sum of *wakālah* fees due from all policies incepted during the last 12 months,

$\sum_{1}^{12} NII_{t-12}$ is 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).

2.3 FROM MODIFIED *MUḌĀRABAH* TO MODIFIED *WAKĀLAH*

Most *takāful* operators in Malaysia have now adopted the *wakālah* model after applying the *muḍārabah* model for more than two decades. They adopted the *wakālah* model only after modifying its structure to entitle the *takāful* operator to a share in the underwriting surplus. This modified *wakālah* model is a departure from the pure *wakālah* model practiced in the Gulf states and the Middle East, a model that prohibits the sharing of surplus. The modified *wakālah* model allows for three returns to *takāful* operators, as authorized by Bank Negara Malaysia (2006):

i. Upfront fees (*wakālah* fee);
ii. Profit from participants' fund; and
iii. Surplus on investment profit from risk fund

The shift to the new model may be triggered by the rapid development in the *takāful* and re*takāful* industry that would sometimes necessitate 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 *wakālah* 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 cooperative than commercial, then the modified *wakālah* model should be hailed as a positive development in the *takāful* industry. Conversely, if the shift would eventually add another source of return to the shareholders, i.e., *wakālah* 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'amīn taᶜāwuni* 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 (*wakālah* fee, investment returns, and underwriting surplus) instead of two, as practiced in the *muḍārabah* model (i.e., investment returns and underwriting surplus).

3. ISLAMIC PRINCIPLES OF SURPLUS DISTRIBUTION

The main controversial issue between Middle Eastern *takāful* companies and most Malaysian *takāful* operators is the sharing of underwriting surplus. The opponent of sharing the underwriting surplus back their contention by decisions taken by highly acclaimed institutions such as AAOIFI, whose Standards on *Takāful* reads: "The *takāful* operator does not share in the (underwriting surplus)," (AAOIFI, 2008). A few major reasons are given to deny the *takāful* operator a share of the underwriting surplus. We shall mention those reasons then review their authenticity and viability as follows:

3.1 THE UNDERWRITING SURPLUS BELONGS EXCLUSIVELY TO THE PARTICIPANTS

AAIOFI Standards on *Takāful* 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 a revenue and a profit for commercial insurance" (Arbouna, 2008 and AAOIFI, 2008).

This assertion by AAOIFI would raise the issue of ownership claimed on the *takāful* contribution paid. On the one hand, the participant has donated the contribution as *tabarruᶜ*, hence, losing title over it as prescribed by the rules of *tabarruᶜ* according to *Sharīᶜah* but on the other hand, he is considered as the exclusive owner of the whole underwriting surplus or a part thereof (Billah, 2003). This requires a juristic scrutiny that investigates the ownership element in *hibah* and the extent of its *Sharīcah* compliance in the *takāful* industry.

There are a number of jurists who emphasized that pure gift (*hibah)* causes the donor to lose title of the object of *hibah*. Ibn Qudamah asserts that "*al-hibah tamlīk*", i.e., *hibah* requires the *wāhib* to enable the beneficiary to own the object of *hibah* (Ibn Qudamah, 1405H). Al -Imām al-Shirazi points out that "*Al-hibah tamlīk bighayri ciwaḍ*", i.e., *hibah* enables the beneficiary to own the object of *hibah* without an exchange) (Shirazi, n.d). In such a case, the juristic implications of *hibah*, as Ibn Nujaym al-Ḥanafī asserts, will be the transfer of *hibah* to the beneficiary/donee, entitling him to hold title over the object of *hibah* (*thubūt al-milk li mawhūb lahu*) (Ibn Nujaym, n.d).

Generally speaking, Shafi'i scholars view *hibah* as the transfer of ownership of an asset without an exchange during one's lifetime on a voluntary basis (Al-Qalyubi and Amirah, n.d). The other schools of jurisprudence refer to the same meaning, with a special emphasis on the element of "no exchange", i.e., *bi ghayri ciwaḍ*, (Almash, 1984). This transfer of ownership would be effective either by way of acquisition (*qabḍ*) on the part of the donee, which is the views of the Shafi'is (Shirbini, 1958) and Hanafis (Al-Kasani, 1982), or by way of offer and acceptance, which is the view of the Malikis (Ibn Rushd, 1988).

This juristic approach is an evidence that *tabarruc* requires the relinquishing of ownership over the object of *hibah*. Since the latter entails the transfer of ownership to the donee, we can arguably say that the *mutabarric* (donor) does not hold any legal or beneficial right or claim over the asset donated. The *hibah* then belongs to a legal entity (*shakhṣiyyah ictibāriyyah*) called the *takāful* fund and administered by the *takāful* operator on the basis of *wakālah* or any *Sharīcah* contract (al-Zarqa', 1999). Having said that, the *takāful* operators and participants are the custodians of the fund and should be free to decide on how the underwriting surplus should be distributed, invoking the doctrine of *shurūṭ* (conditions) in contracts as articulated in Islamic Jurisprudence. Sheikh 'Ali al-Khafif reiterates that ownership requires full possession of the subject matter by the owner, indicating that ownership requires exclusivity (*ikhtiṣaṣ*) and denial (*al-ḥājiz*). The former refers to the exclusive right of the owner to use the subject matter he owns, and the latter refers to the fact that the right of others to use the same subject matter is denied (al-Khafif, 1996 and Abu Zahrah, 1996). In the context of *takāful*, the features of "exclusivity" and "denial" cannot materialize as the participants lose title of the contribution by virtue of *tabarru*ᶜ made. As a consequence of applying the concept of pure *tabarru*ᶜ the surplus is apparently left un-owned, which raises a *Sharī*ᶜ*ah* issue on the status of this surplus. Generally speaking, wealth cannot remain un-owned unless it is created to serve special purposes such as *waqf*, public or cooperative funds, including *takāful* fund. This is to say that the concept of pure *tabarru*ᶜ in *takāful* is not suitable as it would mean that the surplus remains un-owned. The only shroud of right that the donor may still have over his *hibah* is when he donates it in exchange for a counter value, a principle known as "*hibat al-thawāb*", which will be highlighted in the next point.

The issue of ownership of fund is closely tied to the issue of surplus distribution. If it is established that the fund is owned by the *takāful* participants, then the surplus unquestionably belongs to them. However, this is not the case. The pure *tabarru*ᶜ or even *iltizām bi tabarru*ᶜ (commitment to tabarru') casts doubt on the participants' right to own the *takāful* fund. To solve the ownership problem, one may propose the concept of "conditional contribution" to a cooperative fund. According to this concept, a contributor may donate a sum of money for cooperative purposes on condition that the balance, if any, should be returned to him. This will allow him to retain his ownership right over the initial contribution he made, with a provision allowing him to waive his right of ownership over the portion used to indemnify other participants.

The ownership problem can also be tackled if the participants in a *takāful* fund act as depositors rather than donors. In this set up, the *takāful* operator acts as a depository institution, guaranteeing the deposits based on the principle of *wadī*ᶜ*ah yad ḍamānah*. This model is also coupled with a waiver clause in which the participant would waive his right to receive the portion of his *wadī*ᶜ*ah*, which is used by the fund to indemnify other participants.

3.2 *HIBAH AL-THAWĀB* AS A GROUND FOR DISTRIBUTING SURPLUS EXCLUSIVELY TO PARTICIPANTS

Contemporary scholars like al-Quradaghi are of the view that the principle of *hibah al-thawāb* (a gift for an exchange) is a good ground to justify the exclusivity of surplus to the participants only. The principle of *hibah al-thawāb* entails that a donor stipulates a consideration (*thawāb*) from the donee in exchange of the gift. According to Sheikh Quradaghi, the surplus is the *thawāb* that must be given to the donor in exchange of the gift (Qurdaghi , 2006). However, this contention does not stand as a strong evidence for the following reasons:

a. All the Prophetic *ḥadīth*s substantiating *hibat al-thawāb* are based on the contrast between *hibah* (gift) from one side and *thawāb* (exchange) from the other, i.e., total *hibah* for total *thawāb*. Imām San'ani refers to the *ḥadīth* of Aisha (r.a.) who said: "the Prophet (s.a.w.) used to accept *haddiyyah* (gift) and reward its giver (Bukhari)" (San'ani, 1379H). Obviously, the underwriting surplus is remotely understood as the *thawāb* referred to in the aforementioned *ḥadīth*. In the context of *takāful* , the underwriting surplus is actually part of the initial *hibah* (contribution) for which a *thawāb* (indemnification/surplus) is sought, whereas in *hibah al-thawāb*, the *thawāb* should be something different from the *hibah* and not a part thereof. If the same *hibah* is returned to the same donor, then it is called '*umarī* with certain conditions delineated in the compendiums of Islamic jurisprudence (Ali Muhyiddin al-Qurdaghi, 2006).

b. It is true that some of the Prophetic *ḥadīth*s referring to *hibah al-thawāb* have secured some right of ownership to the donors after donation. Ibn Qayyim addressed the issue by approaching some *ḥadīth*s that are apparently in conflict. On the one hand, one *ḥadīth* reads:
"العائد في هبته كالعائد في قيئه" Abu Daud (n.d.)

"He who retracts his *hibah* is like the one who swallows what he vomits"

This *ḥadīth* would make it *ḥarām* to retract a gift after being made voluntarily. This means that the donor would lose title of the *hibah* and cannot benefit from it again. On the other hand, there are a few *ḥadīth*s that secure some right of ownership of the *hibah* by the donor even after donation. Ibn Qayyim mentions the following *ḥadīth* (Ibn Qayyim, 1973):

"الرجل أحق بهبته ما لم يثب منها" (Abū ʿAbdullāh al-Qazwini, n.d.)
"من وهب هبة فهو أحق بها ما لم يثب منها" (Al-Naysaburi, 1990)

"Abū Hurayrah 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 *ḥadīth* is the only piece of evidence attesting to a conditional ownership of the *hibah* by the donor, allowing him to retract his *hibah* if he is not rewarded or satisfied with the reward. However, as clearly understood from the *ḥadīth*, this evidence only gives conditional retraction of the same gift, not a surplus of it. In the case of *takāful*, this *ḥadīth* is not applicable to surplus distribution; rather it is about retraction of *hibah.* Hence, it does not stand as an evidence of the *wāhib*'s ownership of *hibah* after donating it to the *takāful* fund.The apparent conflict between the two aforementioned *ḥadīth*s can be dealt with in a way that both can be applied according to their specific contexts. Despite the weak status of the *ḥadīth* of Abu Hūrayrah stated earlier, as mentioned by Ibn al-Qayyim, the latter would consider both *ḥadīth*s valid by predicating the *ḥadīth* of the prohibition of retracting *hibah* on the *donor* who has given a pure *hibah*, without seeking *thawāb*, while the *ḥadīth* of the permissibility of retraction is predicated on the premise that the donor has stipulated an exchange, of which he is denied or is unsatisfied with it (Shawkānī, 1973 and Ibn Qayyim, 1973).

3.3 THE *ḤADĪTH* OF *NAHD* AS A GROUND FOR SURPLUS DISTRIBUTION EXCLUSIVELY TO PARTICIPANTS

Sheikh Quradaghi also argued that *ḥadīth* of *nahd*/*nihd* is also a good ground for confining the surplus distribution to the participants only. According to Jurjānī, *tanahhud* is defined as an act of contributing an expense in a journey similar to the other companions' expenses (Jurjānī, 1405H and Ibn Quddāmah, 1405H). Al-Bukhārī states in his *Ṣaḥiḥ* that "Muslims did not see any harm in *nahd*" (Bukhārī, 1987). The latter, as Ibn Hajar explains, is "the allocation of a fund in proportion to the number of the participants (in the fund)" (Ibn Hajar, n.d). Although this arrangement was more useful and practical in journeys to provide mutual coverage of expenses, it has been viewed as a mechanism to share risks whether in a journey or otherwise. The *ḥadīth* of *nahd* reads:

Jābir bin 'Abdillah narrated that "...then the Prophet (s.a.w.) dispatched a battalion along the coast, appointing Abū 'Ubaidah bin al-Jarrāh as their leader while they were three hundred including myself. As we reached a certain location, our food finished, thereafter Abū 'Ubaidah ordered all the food of the battalion to be pooled, of which mine was dates. Every day he would feed us a little food until it finished, and then we started getting one date each…" (Bukhārī, 1987). The ḥadīth went on to mention that the battalion thereafter fed on a whale, which they found dead along the coast (Bukhārī, 1987).

Referring to this *ḥadīth* without citing it text, AAOIFI Standards on Takaful provides an explanation to Ibn Ḥajar's definition of *nahd*. AAOIFI arguably maintains that Ibn Ḥajar's definition of *nahd* refers to the underwriting surplus which, according to AAIOFI, should be redistributed solely to the participants so that it could be used in another journey (AAOIFI, 2008). Revising Ibn Hajar's view on this *ḥadīth*, he does not seem to have referred in any way to surplus redistribution to the same participants (Ibn Ḥajar, 1397). The ḥadīth, as we cited it, is completely silent about surplus as there was no evidence of any surplus in the pool of the food established by the companions in that journey. This should open the doors for *ijtihād* to be exercised in view of *maqāṣid al-Sharīᶜah* and the general Islamic financial principles.

3.4 SHARING IN THE UNDERWRITING SURPLUS IS TAKING PEOPLES' PROPERTY UNJUSTLY

This contention is held by prominent scholars like Hussein Hamid Hassan, and Al-Qurdaghi, (Hassan, 2004 and Qurdaghi, 2006). Although there could be a plausible ground for such a view in light of the practices of some *takāful* operators that seize the lion's share of the underwriting surplus, there is no strong evidence adduced by these two renowned scholars in support of their argument that sharing surplus is akin to taking people's wealth unjustly. With the existence of a sound regulatory framework that caps the percentage of the distributable surplus, *takāful* operators will not be in a position to take peoples' property unjustly, nor is it imaginable that the *Sharīᶜah* boards of those *takāful* operators would condone such an injustice to take place. 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, all *takāful* operators to share in the surplus of the risk fund based on a capped ceiling and types of products, a point which will be highlighted in the next item (Bank Negara Malaysia, 2006).

4. EQUITABLE VS. ARBITRARY SURPLUS DISTRIBUTION

A crucial issue arises as to whether the current practice of surplus distribution is equitable or arbitrary. We would address this issue on the premise that surplus distribution is permissible by *Sharīᶜah*, in view of our earlier juristic argument. There are more than one practices of surplus distribution in the *takāful* 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 equitability in surplus distribution. From a *Sharīᶜah* perspective, the whole issue of *takāful*, including that of surplus distribution ratios, is an *ijtihādī* matter that would depend on the interest (*maṣlaḥah*) and customary practices. Actuarial input is equally important to determine the ratios to the extent that the surplus, on the recommendation of the actuary, may not even be distributed in order to boost the reserves instead. Since the underwriting surplus belongs neither to the *takāful* operator nor to the participant, as we argued in this research, the following parameters of equitable surplus distributions are proposed:

i. The surplus means either:
    a. Underwriting surplus (excess of premiums over claims); or
    b. Underwriting surplus plus investment returns.

ii. The ratio of surplus distribution is to be decided by both *takāful* operators and the participants or their representatives in the administrative board.

iii. The *takāful* operator may or may not share in the underwriting surplus depending on the model adopted, which should be approved by the respective *Sharīʿah* board.

iv. It is permissible for a *takāful* operator to dispose of the underwriting surplus with the prior approval of the participants.

v. Equitability in *maṣlaḥah* rather than equitability in numerical ratios. The ratio may not necessarily have a numerical equivalence such as 50:50 in order to have an equitable surplus distribution. The *maṣlaḥah* and ʻ*urf* and ʻ*adālah* (justice) must be the main *Sharīʿah* principles that help determine such ratios.

vi. It is permissible to adopt different surplus distribution ratios to different lines of products.

vii. It is permissible to state in the policy that the ratio of surplus distribution may be reduced as a result of the default record of the participant. This measure is important to urge participants pay their contributions on time, and to be fair with those who are regular in paying their contributions.

viii. The surplus distribution applies only to net surplus, i.e., gross surplus less claims, *wakālah* fee, re*takāful* fee, etc.

ix. It is permissible to adopt different ratios for different classes of *takāful* business, i.e., general and family.

x. It is permissible to distribute surplus in the form of reversionary bonuses.

xi. For equitable surplus distribution, the *takāful* operator can adopt one of the three modes: pro-rata, selective or offsetting.

4.1 PRACTICES OF SURPLUS DISTRIBUTION

Surplus distribution varies according to reasons pertaining to the *Sharīcah* model adopted by *takāful* operators across the world. For purposes of giving an idea on the issue, we would select two *takāful* operators, one international and the other Malaysian. Before that, an overview of surplus sharing practices is needed:

4.1.1 THE OVERSEAS EXPERIENCE

One of the leading Islamic insurance providers in the Middle East is Bank Aljazira in Saudi Arabia. Adopting the *wakālah* model, the company is compensated via agency fees in the form of a. percentage of contribution. This percentage covers:

- The operating cost of Bank Aljazira in running the *takāful* program.

- 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 *takāful* funds, minimize direct expenses related to the *takāful* fund such as issue cost, stamp duty, legal fees, re*takāful* cost, etc. and monitor fraudulent claims.[3]

The Saudi Arabia monetary authority has approved that 10 percent of underwriting surplus to be redistributed to the participants and 90 percent to the shareholders (Liba, 2006).[4] Although it is understood from Bank Aljazira's website that the 10 percent is the minimum redistributed to policyholders, the author is of the view that this is an arbitrary surplus redistribution guideline, which has gone beyond the element of incentives. The continuation of the practice may defeat the whole purpose of *takāful* as cooperative setup and it is highly likely that the *takāful* industry would turn into a profit seeking operation. The unfairness is even bitter when participants are not involved in determining the ratio of surplus distribution. The 10:90 ratio is clearly arbitrary and may cast doubt over its *Sharīcah* compliance in view of the proposed parameters of equitable surplus distribution.

4.1.2 THE MALAYSIAN EXPERIENCE

The Malaysian experience in *takāful* has witnessed two phases. The emergence phase featured the introduction of the Takaful Act 1984. The first *takāful* operator, MNI Takaful, adopted the modified *muḍārabah* model whereby profit, defined as underwriting surplus plus investment returns, would be shared between the *takāful* operator and participants based on a ratio agreed up front. The ratio for MNI Takaful is 20:80 and 30:70 ratios for Syarikat Takaful Malaysia, meaning that 20 percent of profit in the case of MNI Takaful and 30 percent for Syarikat Takaful Malaysia are credited to the shareholders' fund. (Obeidullah, n.d).[5] The second phase is when all Malaysian *takāful* operators recently shifted to the *wakālah* model except Takaful Malaysia, which still applies *muḍārabah* model.

Malaysian *takāful* operators have recently adopted a modified *wakālah* model that would allow them to earn *wakālah* fee, investment returns from the participant fund and a share of the underwriting surplus. Bank Negara Malaysia (2006), in its yet unenforced guidelines, has set limits for surplus/profit sharing, which are as follows:

i. Products with savings elements:
   - Maximum 30 percent of the investment profit; or
   - Maximum 10 percent of surplus.
ii. Product with protection purpose:
   - Maximum 50 percent of surplus; and
   - Additional 10 percent of surplus for *takāful* operator without upfront fees.
iii. Product with protection and savings element:
   - Weightage of the above.

There are different ratios of surplus distribution applied by Malaysian *takāful* operators based on different *Sharīʿah* principles followed. Syarikat Takaful Malaysia, the only company applying *muḍārabah* model, distributes the surplus on a 70:30 ratio for family *takāful*,[6] and 60:40 for general *takāful*. One question may be eminent at this juncture: do the proponents of this model share in the underwriting loss besides sharing in the underwriting surplus? Muhammad Ayub noted that "the *takāful* operator (adopting this *muḍārabah* model) gets the underwriting surplus, but does not bear the underwriting loss" (Ayub, 2007). However, the *qarḍ ḥasan* injection that the *takāful* operator provides in case of deficit would expose it to losses as the *qarḍ* may never be recovered from future surpluses. Besides, the solvency margin that stipulates sound risk based capital (RBC) guaranteed by the share holders fund would demand an additional financial obligation on the *takāful* operator, pushing it to exercise prudence to protect the *takāful* fund and the shareholders fund, albeit separated.

Furthermore, the current practice of combining the profits of investments and the underwriting surplus in one pool under the modified *muḍārabah* model may still be confusing and problematic. Under this model, upon signing the contract the participant is acting both as *mutabarri'* (donor) and *rabb al-māl* (capital provider). This would pose a *Sharīʿah* problem as both capacities are simultaneously in force. This means that the same amount of money is given as *tabarru'* and capital at the same time, raising a question on the element of *niyyah* (intention) upon which contracts must be based. Contrary to hybrid contracts where the legitimacy is based on their sequential nature (e.g. *ijārah thumma al-bay'*, *mushārakah mutanāqiṣah*), the *tabarruʿ* and *muḍārabah* arrangement in *takāful*, being concluded simultaneously with their distinct legal implications would definitely raise a *Sharīʿah* compliance issue unless the two capacities, i.e., donor and capital provider, are well defined and made clear to the policyholder.[7]

The other problem is that the participants are not really involved in determining the ratios of surplus distribution, despite Bank Negara Malaysia's assertion that the "surplus of the risk fund belongs exclusively to the pool of participants, and that the *takāful* operators are allowed to share the surplus or investment profit, based on the contract between the participants and the *takāful* operator" (Bank

Negara Malaysia, 2006). Even though the author argued earlier that the underwriting surplus belongs neither to the participants nor to the *takāful* operators in case of *tabarru*[c], both parties should be involved in determining the ratios and mechanisms of dealing with surplus. A practical way is for the *takāful* operator to dispose of the surplus as it deems fit, subject to prior agreement of the participants (Kassim, 2005). Another manifestation of equitable distribution would be the allocation of surplus to the policyholders by means of reversionary bonuses every one, two or three years, the percentage of which would be decided by the actuary of the *takāful* operator (Ariff, 1991).

Takaful Ikhlas is another *takāful* operator that is entrenching itself in the Malaysian *takāful* market. As far as surplus is concerned, the company states the following in its family *takāful* 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 percent**.** 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.[8]

The 10 percent charge is justified based on the following *Sharī*[c]*ah* ground:

a. The 10% is an incentive fee based on the contract of *ju*[c]*ālah* (performance fee).
b. The verse in the *Qur'ān* (4:29), which considers *riḍa'* (satisfaction) as one of the basis of a valid contract.
c. The *ḥadīth*:
   "المسلمون على شروطهم إلا شرطا حرم حلالا أو أحل حراما" (Al-Tirmīdhī, n.d.)
   "Muslims are bound by the conditions [they impose on each other], except a condition that prohibits the permissible or permits the prohibited."[9]

I would say that the *ju*[c]*ālah* 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 *juᶜālah* which is the "payment of a reward for the uncertain fulfillment of a work" (Shirbini, 1977). While there is no *Sharīᶜah* problem with the 10 percent performance fee, a *Sharīᶜah* concern may arise as to the term "surplus administration charge" deducted from the risk fund in favor of Takaful Ikhlas. The Dallah al-Barakah *Sharīᶜah* Committee would disagree with charging an administration fee from the underwriting surplus. It maintains that administration fees must be known and paid up front, regardless of whether there is surplus or not. (Abu Ghuddah and Khojah, 1997)

On the other hand, HSBC Amanah Takaful, used to take 80 percent from the risk fund as incentive while 20 percent will be reserved for distribution among eligible participants.[10] The surplus distribution is based on pro-rata basis based on the contributions made during the financial year if it is more than RM10. However, current practice of HSBC Amanah varies according to products. An example of this would be:

My view is that the 80 percent share is quite high and a revision of this ratio would be more in line with the nature and objective of *takāful*, let alone the equitable distribution.

An opposite to HSBC Amanah Takaful is eTiQa, which is currently adopting a 80:20[11] ratio for family *takāful*, i.e., 80 percent to participants and 20 percent to eTiQa. As for general *takāful*, a ratio of 50:50 is adopted, which seems quite equitable and in line with Bank Negara Malaysia's unofficial guidelines. The paragraph on surplus sharing reads:

> We will receive 50 percent 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 *takāful* certificate. The surplus will not be payable if the participant have made claims under his certificate.[12]

5. CONCLUSION

Two important conclusions are eminent. The first one relates to the right of both *takāful* operator and the participant to share in the surplus. Since the surplus belongs to neither, both should act as custodian of the *takāful* fund and thus should be free to decide on the best way to dispose of it, including its redistribution on an agreeable ratio and in the light of *maqāṣid* and principles of *Sharī^{c}ah*. Whatever ratio is proposed, it must be approved by the *Sharī^{c}ah* advisory committee of the takaful operator. It is, however, highly advisable for takaful operators as much as possible not to share in the surplus to abate the ongoing polemics on this issue. They are instead urged to explore new models that will resolve the equation of ownership and its impact on surplus. The second conclusion emphasizes the importance of formulating adequate *Sharī^{c}ah* parameters for equitable surplus redistribution. We have made an attempt to shed some light on these parameters, but further *ijtihād* is needed to come up with sound and practical parameters that would enhance the *takāful* industry locally and abroad. By and large, some *takāful* operators are adopting equitable ratios of surplus distribution, but others still need to revise their ratios not only to satisfy the dictates of *takāful*, but also to remain competitive in the market.

ENDNOTES

1. The *Sharī^{c}ah* Advisory Council of Bank Negara Malaysia (the Council) has made the resolution that the distribution of surplus from *tabarru^{c}* fund in takaful scheme and the application of *wakālah* contract in deposit instrument is permissible from *Sharī^{c}ah* perspective. The Council's resolution in allowing the distribution of surplus from *tabarru^{c}* fund (for both family and general takaful plans) to the participants/certificate holders and takaful operator is based on the premise that *takāful* contract is generally established on the *Sharī^{c}ah* principles of *tabarru^{c}* (donation) and *ta^{c}āwun* (mutual cooperation), apart from the agreement among the contracting parties. In the formulation of takaful product, the principle of *tabarru^{c}* has been the main underlying *Sharī^{c}ah* principle, although the application of other principles such as *wakālah* and *muḍārabah* also complement the takaful operational structure. The Council's resolution to allow such distribution is also based on the permissibility of performance fee for the *takāful* company. It is noted that in general, such method of distribution is practiced by several *takāful* companies in the Middle East" (see press statement of Bank Negara Malaysia at http://www.bnm.gov.my/index.php?ch=8&pg=14&ac=1511 retrieved on June 12th, 2010). The Governor of Bank Negara Malaysia cited competitiveness as the main driver to surplus sharing in the *takāful* industry.

She stated that "To remain competitive, *takāful* operators need to capitalize on their niche position and build on the unique feature inherent in *takāful* products that is the surplus-sharing element, which can make *takāful* an attractive alternative instrument" (see http://www.bnm.gov.my/view.php?dbIndex=0&website_id=1&id=382, retrieved on 12 June 2010.)

2. AAOFI's definition of surplus reads: "(the surplus) is the residue of the participants' premiums as well as the reserves and their returns, after deducting all expenses and paid and unpaid claims during the financial year. This (residue) is not profit but is called surplus", see AAOFI Standards on Takaful (Manama: AAOFI, 2004-2005), p. 451.

3. See: http://www.baj.com.sa

4. See: http://www.sama.gov.sa/ar/insurance. See also Dr. Mohd. Liba, *al-Ta'mīn al-Taᶜāwunī wa tatbiqātuhu Fī Bank al-Jazīrah wa Sharīkah Ikhlās Li al-Takāful Bi Mālīziyah*, a PhD Dissertation, 2006, p. 249. In an International Conference on Takaful and Re Takaful held in Kuala Lumpur in November 2008, I openly asked Dr. Daud Taylor, the managing Director of Bank al-Jazirah about the current ratios of surplus distribution in his Bank, to which he clarified to the audience that the ratio is currently 70:30 to the Bank and the participants respectively. The clarification provided by Dr. Daud Taylor is on record by CERT, the organizer of the Conference.

5. Professor Obeidullah relied on information provided by http://www.takaful-malaysia.com and http://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 the 70:30 ratio whereby this ratio is for family *takāful*, and 60:40 for general *takāful*.

6. See previous footnote. As of October 2008, the company announced a 15 percent *muḍārabah* surplus from the participants' net contributions.

7. See my presentation on Critical Issues in *takāful* and Re-*takāful*, a paper presented at the *International Summit on Mu'amalat*, 2008 Jakarta, Indonesia.

8. Ikhlas Family Takaful Certificate, p. 21

9. Ibid.

10. See: http://www.takaful.hsbcamanah.com.my

11. An interview with Dr. Zulkifli Zakaria, Vice President and Head of *Sharīcah* 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.

12. Takaful Contract (eTiQa), p. 12.

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