THE COMMERCIALISATION OF MODERN ISLAMIC INSURANCE PROVIDERS: A STUDY OF TAKAFUL BUSINESS FRAMEWORKS IN MALAYSIA

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ABSTRACT
A commercial insurance contract is deemed invalid by many Muslim scholars due to the fact that it is a mu`awada (financial exchange) contract, which is overwhelmed by prohibited elements such as gharar (uncertainty), riba (interest), and maysir (gambling). As an alternative, a Shari`a-compliant insurance scheme (also known as takaful) that supposedly run on the principles of mutual cooperation was proposed by the scholars and subsequently institutionalized in the late 1970s. Nevertheless, after more than 30 years, it appears that the majority of takaful operators currently exist worldwide were established as joint-stock or public limited companies (PLCs). As a result, it could be argued that the original concept of takaful was later overshadowed by the element of profit-making as observed in commercial insurance entities. This paper therefore sets out to examine those issues which directly relate to this form of commercialisation. It argues that since the establishment of insurance companies based on commercial framework is impermissible, it could possibly affect the validity of present takaful arrangement. This study is mainly qualitative and relies greatly upon the documentation method. It is also based on a fieldwork method, since the business models adopted by several takaful operators in Malaysia are carefully examined. In general, it is found that the characteristics of a commercial takaful entity may not necessarily be similar to that of its conventional counterpart.

Keywords: Takaful, tabarru`, mudarabah, ji`alah, wakalah.

1.0 Introduction/Background

The issue of the legal status of insurance contracts has been discussed and debated by Muslim jurists since as early as the 18th century and has continued for more than a century.1 To date, Muslim scholars from all over the world have issued hundreds of legal opinions regarding insurance contracts, either as individual opinions or group resolutions. Some regard the insurance contract to be invalid on

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various grounds, while others maintain its permissibility based on different sets of arguments.

Regardless of the above polemics, the majority of Muslim scholars seem to have reached a more balanced resolution by not regarding all types of insurance contracts as forbidden. To be specific, they argue that *ta'min tijari*, commercial insurance, is forbidden, while *ta' min ta'awuni or tabaduli*, mutual or co-operative insurance, is considered valid. This particular resolution has been reached at various forums, including the second conference of the Islamic Research Academy held in Cairo in 1965, the tenth meeting session of the Council of Senior Scholars of Saudi Arabia held in Riyadh in 1977, the first session of the Islamic *Fiqh* Academy under the auspices of the Organization of Islamic Conference (OIC) held in Mecca in 1398H/1978M and the second meeting of the above Academy in 1406H/1985M.

The above resolutions seem to have received a positive response from Muslim countries as indicated by the establishment of Islamic insurance institutions, also known as *takaful*, all over the world. From the existence of only one Islamic insurance provider in 1979, there are currently 161 Islamic insurance companies

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2 Even though the members of the conference agreed on the permissibility of mutual insurance, they were silent on the legal status of commercial insurance since more researches need to be conducted and more input need to be obtained from economists, lawyers, society and Muslim scholars from all Islamic countries. See al-Qarradaghi, pp.155-156.


4 In the latter forum, which is considered by many scholars as the starting point of Islamic insurance evolution, the following resolutions were reached which clearly condemn commercial insurance while approving of co-operative insurance: (1) The commercial insurance contract, with a fixed insurance premium, as practised by commercial insurance companies, contains substantial *gharar*, which renders the contract defective. Consequently it is legally forbidden; (2) The alternative contract that respects the principles of Islamic transactions is the co-operative insurance contract, which is built on the principles of *tabarru*, voluntary contributions, and *ta`awun*, mutual co-operation. The same applies with regards to reinsurance, which should also be built on principles of mutual co-operation; (3) The Academy calls on Islamic countries to exert effort toward establishing mutual co-operative insurance institutions, as well as ones for mutual co-operative reinsurance, so that Islamic economies may be freed from exploitation, and all other violations of the system that God has accepted for this Muslim community. AAOIFI, *Shar`i`a Standards for Islamic Financial Institutions 1429H-2008* (Bahrain : AAOIFI, 2008), p.482. al-Qarradaghi, p.160.
operating in 32 different countries. Interestingly, almost all of these companies were established as joint-stock or public limited companies rather than purely mutual or co-operative entities as suggested by the resolution. Only Sudan can claim that its Islamic insurance companies operate under pure co-operative principles. This phenomenon seems to suggest that the original resolution may no longer be applicable to the modern takaful set-up. It is believed that the major disadvantage of mutual and co-operative organizations, i.e. that they can only obtain resources from their members and cannot raise equity capital, has strongly demotivated takaful providers from being established as mutual companies. Hence, one big question arises as to whether this form of ‘commercialization’ is permissible from the Islamic point of view, particularly when the arrangement is subjected to the rules of prohibited gharar. This paper aims to examine this issue in the light of the Malaysian takaful industry practices.

2.0 The Meaning of Islamic Insurance (Takaful)

2.1 Islamic Insurance and its Synonyms

Before critically analysing the above issue, it is worth mentioning here that Islamic insurance is also known by several other terms, which include Co-Operative Insurance, Takaful as well as Halal Insurance. The use of these different terms can easily be inferred from the names of the companies which are known to offer Shari`a compliant insurance products throughout the globe. The first term, i.e. Co-Operative Insurance, is mainly used by the companies in the Middle Eastern region, particularly Saudi Arabia and Sudan. For example, in Saudi Arabia, more than half of the companies incorporated therein are named

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5 This figure is however updated as of 2008. The latest figure has yet to be published when the report was issued. See Ernst and Young, ‘The World Takaful Report 2011: Transforming Operating Performance’ May 2011, p.16. [Accessed: 12 July 2011].
after the term ‘Co-operative Insurance’. This is not surprising, because the law of the country requires any insurance company (registered in Saudi) to operate in accordance with the co-operative insurance method. Moreover, co-operative insurance is basically considered as valid by the majority of Muslim jurists, including Saudi’s Council of Senior Scholars. Nevertheless, as will be explained in the coming chapter, the operational dimensions of Islamic insurance may not necessarily be similar to co-operative insurance.

The term ‘Halal Insurance’, on the other hand, was popularised by the first ever independent Islamic insurance provider in the United Kingdom called Salaam Halal Insurance. The term, however, appears to have faded away recently, as the company ceased to accept new business due to unfavourable market conditions. Takaful is perhaps the most popular term these days, since it is extensively used by the industry players as well as by academia. In Malaysia, a special act called the Takaful Act was introduced in 1984 to administer the operation of Islamic insurance companies in the country. Later in 2013, the Act was repealed and replaced by a more comprehensive Act called the Islamic Financial Services Act 2013 (IFSA). Consequently, takaful is statutorily synonymous with the notion of Islamic insurance in Malaysia. Many international events and published reports are also seen as proposing takaful as the proper term for the Islamic insurance industry in general. Some of the prestigious events regarding Islamic insurance

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8 In Article 1 of the Law on Supervision of Co-Operative Insurance 2003, it is stated that: “Insurance in the Kingdom shall be undertaken through registered insurance companies operating in a co-operative manner...and in accordance with the principles of Islamic Sharī‘a”. Quoted from Asem Samih Ahmad, ‘A Critical Study of Takāful (Islamic Insurance) and Its Modern Implementation’ (PhD Thesis, University of Birmingham, 2006), p.307. However, there seems to be confusion in the Act, as although it is supposed to cover insurance companies ‘operating in a co-operative manner’, it is not clear what this means, especially as the law refers to joint-stock companies, not mutual societies. See Rodney Wilson, ‘Concerns and Misconceptions in the Provision of Takaful’, in Islamic Insurance: Trends, Opportunities, and the Future of Takaful, ed. by Sohail Jaffer (United Kingdom: Euromoney Institutional Investor Plc., 2007), p.82.
10 Apart from ‘Co-Operative Insurance’, many Islamic insurance companies were named after Takaful, Islamic Takaful or Co-Operative Takaful.
are known as the International *Takaful* Summit (held annually in London) and The World *Takaful* Conference (held annually in Dubai). There are also many reports published by auditing firms and rating companies such as Standard & Poor’s, Ernst & Young and AON that directly address Islamic insurance as *takaful*. One of the significant reports that highlights the overall performance of the Islamic insurance industry worldwide is The World *Takaful* Report, which is published by Ernst & Young on an annual basis.

It should be noted, however, that not all parties seem to agree with the use of *takaful* to connote the whole idea of Islamic insurance. For example, in most Arab countries, particularly Saudi Arabia and Sudan, *takaful* appears to specifically refer to the Islamic version of life insurance schemes. The Islamic version of general insurance, on the other hand, is purposely distinguished by the using of the term Islamic insurance or co-operative insurance. In Swiss Re’s serial publication *Sigma*, it is also stated that Islamic insurance is distinguished from *takaful*. While the former refers to all concepts of Islamic insurance, the latter refers specifically to insurance models that use segregated funds for policyholders and shareholders. Unlike the Saudis and Sudanese cases, the scope of usage of the term *takaful* in the latter case may well include Shari`a -compliant life and non-life insurance schemes. The main difference between *takaful* and Islamic insurance as suggested by Swiss Re seems to concentrate on the organizational structure of the insurance arrangement.

Despite the above differences, this paper will consider the notion of both Islamic insurance and *takaful* as interchangeable. This is perhaps consistent with present international practices, as shown earlier. Moreover, since this research is restricted to the Malaysian market, in which the *Takaful* Act (and later IFSA 2013) has been enacted, the use of the term ‘*takaful*’ is perhaps more accurate. Hence, the term ‘*takaful*’ will be used interchangeably with Islamic insurance throughout the paper as if they were exactly identical.

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12 Ahmad, p.315, Ibrahim, p.2.
2.2 The Definition of Takaful

*Takaful* is an Arabic noun derived from the root verb *kafala*, which means to guarantee, secure, ensure or be liable for.\(^{14}\) From this base comes the derived stem *takafala*, which means to guarantee each other, to vouch for each other, or to be jointly liable or responsible.\(^{15}\) *Takaful*, which is the verbal noun of the latter, literally means mutual or joint responsibility, solidarity or mutual agreement.\(^{16}\)

According to the *Oxford Dictionary of English*, *takaful* means a type of insurance system devised to comply with *Shari`a* laws, in which money is pooled and invested.\(^{17}\) This rather technical definition tends to show that the term ‘*takāful*’ has already been acknowledged by Western scholars to represent the idea of Islamic insurance.

Perhaps one of the most established and authoritative technical definitions of *takaful* could be found in the Malaysian *Takaful Act* 1984. According to Section 2 of the Act, *takaful* is defined as follows:

*Takaful* means a scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose.

As the first statutory definition of *takaful*, this definition seems to be very general and rather imprecise. Firstly, it appears as if the participants are entitled to receive financial aid or compensation (from the *Takaful Fund*) in any situation of need, not necessarily subjected to the occurrence of certain risks or perils, as *takaful* is supposed to mean. Secondly, it tends to signify that *takaful* is a pure mutual undertaking in which no involvement from outside or a third party is expected. Nevertheless, the latter inconsistency is perhaps resolved by the subsequent

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\(^{16}\) Wehr, Ba`albaki.

definitions which clearly link *takaful* to a business arrangement. In fact, the Act is mainly enacted to provide for a procedure for the registration of *takaful* businesses and to establish the conditions under which they operate.

A more conclusive and precise definition of *takaful* can perhaps be found in standards or guidelines produced by the two most authoritative bodies in the Islamic finance industry, namely the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB). AAOIFI in its *Sharī’a Standards* defines Islamic insurance without mentioning the word *takaful*, as follows:

Islamic insurance is a process of agreement among a group of persons to handle the injuries resulting from specific risks to which all of them are vulnerable … involves payment of contributions as donations and leads to the establishment of an insurance fund that enjoys the status of a legal entity. The resources of this fund are used to indemnify any participant who encounters injury … The fund is managed by either a selected group of policyholders, or a joint stock companies that manages the insurance operations and invests the assets of the fund, against a specific fee.’

Likewise, IFSB, in its published guidelines entitled *Guiding Principles on Governance for Takaful (Islamic Insurance) Undertakings*, describes *takaful* as follows:

*Takaful* is the Islamic counterpart of conventional insurance, and exists in both Family (and “Life”) and General forms. *Takaful* is derived from an Arabic word that means joint guarantee … In a *Takaful* arrangement the participants contribute a sum of money as *Tabarru’* commitment into a common fund that will be used mutually to assist the members against a specified type of loss or damage. The underwriting in a *Takaful* is thus undertaken on a mutual basis, similar in some respects to conventional mutual insurance. A typical *Takaful* undertaking consists of two-tier

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18 In Section 2 of the Act it is also defined that *takāfūl* business means business of *takāfūl* whose aims and operations do not involve any element which is not approved by the *Sharī’a*. Furthermore, in Section 3, it is clearly stated that *takāfūl* business shall be divided into two classes; (1) family solidarity business, and (2) general business, which is not family solidarity business.

19 Wilson, p.80.

20 AAOIFI, *Sharī’a Standards* p.471.
structure that is a hybrid of a mutual and a commercial form of company – which is the Takaful operator (TO) – although in principle it could be a pure mutual structure.\textsuperscript{21}

Based on the above definitions, it is clear that takaful is supposed to be built upon the principle of mutual help amongst the policyholders, termed participants. Each of them would voluntarily make a contribution to a common fund (known as the Participant’s Risk Fund [PRF]) on the basis of tabarru`, a donation, which will be later used to pay compensation to any of the participants who suffer losses or injuries from the insured events. This particular feature renders takaful comparable with conventional mutual or co-operative insurance, whereby the participants are seen sharing and distributing the risks amongst themselves instead of transferring them to a third party. Through this co-operation, the participants are considered to be both the insured and insurer at once.

However, both mutual insurance and takaful are likely to differ in terms of the management of the fund. While the insurance fund in a mutual or co-operative entity is completely owned and managed by its own members\textsuperscript{22}, a takaful fund, on the other hand, can possibly be managed by a joint-stock commercial entity (whilst its ownership maintains with the participants). Hence, based on this feature, takaful may not necessarily be restricted to a purely mutual structure but could also involve a commercial setup, as the company who manages the fund (i.e. the takaful operator) is actively seeking profits by charging certain fees from the takaful fund. In reality, almost all takaful operators these days are joint-stock or public limited companies instead of pure co-operative or mutual organizations.\textsuperscript{23} As a result, takaful could be well described as a hybrid of a

\begin{itemize}
  \item \textsuperscript{22} According to the International Co-operative Alliance, a co-operative is defined as an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly-owned and democratically controlled enterprise. Quoted from Ezamshah Ismail and Shaikh Hamzah Abdul Razak, \textit{Takaful and Actuarial Practices} (Kuala Lumpur : INCEIF, 2009), p.73. \textit{The Oxford Dictionary of English}, on the other hand, defines co-operative (noun) as a farm, business, or other organization which is owned and run jointly by its members, who share the profits or benefits.
  \item \textsuperscript{23} Sudan is claimed to be the only country where an Islamic insurance operates under pure co-operative principles. Please refer to Ahmad, p. 253.
\end{itemize}
mutual and a commercial form of company. The mutual form of takaful could be inferred from the relationship amongst the participants, while the relationship between the participants (or takaful fund) and the takaful operator would constitute the commercial form of the arrangement. The latter relationship, especially which applies to the Malaysian takaful environment, will be further explored and critically examined in the forthcoming sections of this paper.

3.0 The Commercialization of Takaful

As previously stated, the majority of the takaful schemes available today are initiated and managed by joint-stock or public limited companies (which are obviously commercial in nature), rather than purely mutual organizations. Thus, it is perhaps right to suggest that takaful cannot be separated from the notion of ‘commercialization’.

The word ‘commercialization’ comes from from the root word ‘commerce’, which refers to the activity of buying and selling, especially on a large scale. It originates from the middle of the 16th-century French or Latin word ‘commercium’, which means trade or trading.24 As an adjective, the word ‘commercial’ can mean relating to commerce (i.e. involving or relating to the buying and selling of goods) as well as done for profit (i.e. done with the primary aim of making money).25 When a particular organization or activity is labelled as commercial (e.g. commercial bank or insurance) it is concerned with making money or profits rather than, for example, with scientific research or providing a public service.26

Related to the above, the word ‘commercialize’, a verb, means to manage or exploit (an organization, activity, etc.) in a way designed to make a profit.27 If something is commercialized, it is used or changed in such a way that it makes

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27 The Concise Oxford Dictionary of Current English
money or profit, often in a way that people disapprove of.\textsuperscript{28} It also means to apply business principles to something or run it as a business and to exploit something for financial gain.\textsuperscript{29} Therefore, the word ‘commercialization’, which is a derivative (noun) of ‘commercialize’, can be defined as a process or state of managing, exploiting or altering something in a way that would make it very much synonymous with the notion of business, whereby the element of profit is undoubtedly sought after. This profit-seeking motive can sometimes have a negative connotation, as it tends to denote the enrichment of one party at the expense of another.

In this paper, \textit{takaful} is considered to be greatly affected by the notion of commercialization, since most of the current \textit{takaful} organizers, if not all, are business entities or corporations that see the opportunity of making money and profit out of providing/instigating management services to a rather socially-inspired undertaking. In the context of the Malaysian \textit{takaful} industry, in particular, it appears that the mutual or co-operative-based organizational structure is almost irrelevant to the operators. In fact, it was identified earlier by the author that all the \textit{takaful} schemes in Malaysia are initiated, marketed and organized by commercial organizations backed by the leading financial giants (which are obviously profit-seeking entities). Of all the 12 \textit{takaful} companies currently operating, only one appears to be jointly owned by a co-operative body.\textsuperscript{30} Nevertheless, as will be explained next, this may not necessarily render the \textit{takaful} arrangement similar to commercial insurance, which is considered forbidden by the majority of Muslim scholars. Yet its commercialization can still invoke certain issues which need to be carefully analyzed in order for the former to be completely dissociated from the latter. For instance, some possible \textit{gharar}

\textsuperscript{28} \textit{Collins Cobuild Advanced Learner’s English Dictionary}.

\textsuperscript{29} \textit{Bloomsbury Concise English Dictionary}.

\textsuperscript{30} Great Eastern Takaful Sdn. Bhd. (GETSB) is currently owned by The Great Eastern Life Assurance Company Limited and \textit{Koperasi Angkatan Tentera Berhad}, The Malaysian Armed-Forces Co-Operative Limited. Nonetheless, since the majority of GETSB’s share capital was contributed by the former, it would not render GETSB as a co-operative body.
incidences can be detected in the operation of certain operators that might render the commercial side of takaful invalid.³¹

3.1. Commercial Takaful vis-à-vis Commercial Insurance

At first sight, takaful providers may seem to be similar to commercial insurers due to the fact that they are mostly, if not all, joint-stock companies or corporations which aim to make money or profit from the services rendered. Nevertheless, upon deeper investigation the notion of ‘commercial’ may prove to be different in both entities, and thus would lead to different legal rulings. It appears that the notion of ‘commercial’, which is synonymous with a profit-seeking motive, has led to the banning of conventional insurance but not takaful in general. Perhaps this distinction can be best explained by the fact that Shari‘a law views a profit-seeking motive as legitimate so long as it conforms to the rules, ethics and norms of a business. This includes the avoidance of dealing with riba, gharar, maysir and other forms of unfair practice.

As maintain by many scholars, the operation of a commercial insurer is very much affected by the above elements, particularly gharar, and thus has led to its prohibition. On the other hand, the revenue and profit for a commercial takaful operator should only be sought through legitimate or Shari‘a -compliant means, which are supposed to be free from those prohibited elements. In Malaysia, and perhaps worldwide, this is mainly done through the application of several nominate contracts such as wakala bi ajr, remunerated agency, mudaraba, profit sharing, and ji`ala, reward. As will be explained in detail later on, these contracts appear to allow the operators to legally secure their revenue and profit consistent with their role as a hired agent, entrepreneur or worker respectively.

Yet these contracts, which are obviously not in the *tabarru*` category, are still subjected to the rules of *gharar* and thus can possibly be judged as invalid (due to *gharar*) if their conditions are not fully met. Moreover, in most cases, the *takaful* operators are also seen as taking advantage of combining two or more of these contracts in order to obtain higher revenue and profit. In addition, the drive to secure higher profits can sometimes inspire the *takaful* operator to engage in rather controversial practices. These may include the modification of the contract’s original specifications (such as the altered definition of profit in the *mudaraba* contract) and the application of the contract in a disputed area (such as applying the *ji`ala* contract to justify the sharing of an underwriting surplus).

Regardless of these controversies, the correct application of these contracts is considered to be the main reason for the validity of commercial *takaful* as opposed to commercial insurance. Perhaps the application of these contracts has made certain specifications of the commercial notion in *takaful* substantially different from that found in commercial insurance. The explanations of why the notion of ‘commercial’ in *takaful* is different from commercial insurance due to the application of the above-mentioned contracts follow in the next sections.

### 3.1.1 Responsibility to Indemnify

In commercial insurance, the concept of risk transfer is applied whereby the insurance company is seen as taking full responsibility to indemnify the insured (during the occurrence of an insured peril) in exchange for premiums received from the latter. This transaction is obviously *mu`awada*, financial exchange, in which the insurer aims to make a profit out of the insurance operation.\(^{32}\) In other words, the whole insurance arrangement is initiated and endorsed by the company’s own name under the notion of a pure sale contract. Conversely, the concept of risk sharing amongst the participants (instead of risk transfer) is applied in *takaful* whereby the operator only assumes the role as an agent, worker

\[^{32}\text{AAOIFI, Shari`a Standards for Islamic Financial Institutions 1429H-2008 (Bahrain : AAOIFI, 2007), p.483.}\]
or entrepreneur to the takaful arrangement, but not as an insurer.\textsuperscript{33} It is the group of participants that is actually considered to be the insurer (as well as the insured) in this arrangement, similar to mutual or co-operative types of insurance, based on the principles of \textit{tabarru}` and \textit{ta`awun}.\textsuperscript{34} In short, the commercial aspect of the takaful operator in this regard is limited to the aspect of providing management services to the insurance undertaking, which in principal is initiated by the participants. Even though this can also be considered as \textit{mu`awada}, it is obviously underlain by several contracts other than sale, i.e. \textit{wakala bi ajr}, mudaraba or \textit{ji`ala}.

### 3.1.2 Accounts Management

Following the above feature, the takaful operator is required to maintain two separate accounts, one for the shareholders’ rights and liabilities and the other for the rights and liabilities of the participants or policyholders.\textsuperscript{35} To be specific, all contributions paid by the participants are credited into the latter account, which is commonly known as the Participant’s Risk Fund (PRF),\textsuperscript{36} to cover all the expenses related to the provision of the insurance services. Any residual amount recorded by the account (after deduction of expenses and indemnity amounts) is considered as surplus and remains the property of the participants collectively.\textsuperscript{37} The company, or to be specific, the shareholders, has no rights to whatever amount that is credited to or remains in this account apart from their stipulated proportion of \textit{wakala} charges, and in some cases may also include performance

\textsuperscript{33} \textit{Ibid.}, al-Qarradaghi, p.212.
\textsuperscript{34} It is stated by AAOIFI that ‘In Islamic insurance, the insurer and the participant are in fact the same person although they differ in recognition, whereas the insurer and the participant are totally different in commercial insurance.’ Refer to AAOIFI, \textit{Shari`a Standards}, p.484.
\textsuperscript{35} \textit{Ibid.}, p.472.
\textsuperscript{36} This is applicable to General Tak\textsuperscript{a}f\textit{ul} only whereby all of the contributions will be regarded as \textit{tabarru}` (or \textit{hiba bi sharf `iwa`)}. In Family Tak\textsuperscript{a}f\textit{ul}, another account called the Participant’s Investment Account (PIA) is created on top of PRF. A portion of the participant’s contribution will be allocated to PIF for savings and investment purpose.
\textsuperscript{37} AAOIFI, \textit{Shari`a Standards}, p.483.
fees. On the other hand, there is no need for the commercial insurer to hold two different accounts, since all premiums collected are immediately owned by the company in exchange for its insurance protection. Obviously, this is parallel to the characterization of insurance as a contract of sale, whereby the premium (paid by the policyholder) is considered to be the price, while the financial protection (offered by the insurer) is regarded as the object of sale. Consequently, any remaining premiums (after deducting claims and other operating expenses) also belong to the latter.

3.1.3 The Sources of Profit

As a result of the previous two characteristics, the definition and recognition of profit for both takaful and insurance companies should also be different from one another. Perhaps this could be the ultimate test for a commercial takaful operator, since the over-emphasis on maximization of profit could possibly lead it beyond the limit of a legitimate commercial entity due to its tendency to engaging in prohibited elements such as gharar, jahala and so on. The revenue and profit for commercial insurers are mostly sourced from the premiums paid by the policyholders, since they constitute part of the former’s assets. The more premiums it collects and the less compensation it pays, the bigger profit it will make. Technically, an underwriting surplus, which is generally defined as the difference between the premiums collected and the subsequent outflow (i.e. claims, reserves, operational expenses, etc.), is recognized as profit attributable to the shareholders in commercial insurance. Apart from this primary source, an insurer will also gain revenue and profit from investing its own capital as well as the above premiums in various fields including those associated with riba, gharar, maysir and other prohibited elements.

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38 The performance fee is normally charged as a percentage from the surplus recorded by the participants’ account. It is argued that the operator is permitted to on the basis of the ji’āla contract. This practice is however controversial and will be dealt in the coming research paper.  
39 Al-Qarradāghi, p.211, AAOIFI, Shari’a Standards, p.483.  
40 AAOIFI, Shari’a Standards, p.483.  
41 Al-Qarradāghi, p.214.  
42 Ibid.
This is not the case for a commercial takaful operator, since it does not automatically own all the contributions paid by the participants as well as the surplus recorded in the latter’s account. Due to its role as a mere trustee, any remaining amount in the PRF is not regarded as the shareholders’ profit. Instead, it remains the property of the policyholders as a group, and could partly or wholly be distributed between them under the notion of surplus-sharing.\(^{43}\)

Notwithstanding that, a commercial takaful operator can still acquire revenue and profit from the participants’ contributions consistent with its role as an agent or manager of the pooled fund. This can be in the form of fees and charges imposed on contributions and the PRF or through a share in the profit or surplus of the Fund, which corresponds to the application of several specific contracts that underlie the relationship between the participants (or PRF) and the operator. In the latest guidelines issued by BNM, which takes effect on 1\(^{st}\) October 2011, the following requirements need to be observed by takaful operators in determining the appropriate amount of the above incomes:\(^{44}\)

1. There must be a specific and clear intended outcome from the work undertaken to justify the remuneration. There shall not be double charging within a takaful product;

2. The remuneration to be taken shall be appropriate and reasonable, and determined with due regard to provide fair treatment to stakeholders;

3. Implications on takaful funds, in particular on the fund’s long-term viability, shall be considered; and

4. The level of remuneration to be taken must be commensurate with the complexity of the services rendered and the associated risks.


Below is a summary of possible income for *takaful* companies, particularly in Malaysia, that may constitute profits for the shareholders.

### 3.1.3.1 Fixed *Wakala* Fees and Charges

As an agent who manages the whole *takaful* operation, the company is entitled to charge fees from the participants’ contributions based on the contract of *wakala bi ajr*, remunerated agency. In most cases, a fixed general *wakala* fee is charged upfront in the form of an agreed percentage, up to 40 per cent of the participants’ contribution. According to Wan Deraman and Ismail, this upper limit is regulated by the Central Bank of Malaysia (*BNM*), though the specific guidelines pertaining to this rule could not be found by the author.\(^{45}\) In contrast to this general fee, some companies, such as Prudential BSN Takaful Berhad (PBTB), may charge a more specific *wakala* fee from the participants’ contributions such as a service *wakala* charge and a risk management *wakala* charge to differentiate between two main types of agency tasks.\(^{46}\) Another company, MAA Takaful Berhad (MATB), seems to charge a *wakala tharawat* fee for investing the *takaful* fund. Basically, the rates of these upfront charges is determined by two main factors: (1) the level of management expenses expected to be incurred by the shareholders’s fund in servicing the *takaful* certificates throughout the contract term; and (2) an appropriate provision of margin to compensate shareholders for the effort taken in managing *takaful* operations.\(^{47}\).

From these charges, the shareholders’s account may be supplied with profit (at the end of a particular financial year) if the operational expenses are lower than the overall *wakala* fees received. In practice, however, the *wakala* fees are argued to be only sufficient to cater for distribution (agent’s commission) and management

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\(^{45}\) This upper limit applies to *takāful* operators in Malaysia since it is regulated by the Central Bank of Malaysia. For other countries, particularly in the Middle East, the *takāful* operator may charge higher rate of the *wakāla* fees which is up to 80 percent from the participants’ contributions since it is not regulated. Interview with Wan Jemizan Wan Deraman, TISB’s Assistant Vice President *Shari‘a* Compliance at TISB Head Office in Petaling Jaya, Selangor on the 4\(^{th}\) September 2009. Also Interview with Ahmad Zaiem Ismail, Head *Shari‘a*, ETB at ETB Head Office in Bangsar, Kuala Lumpur on the 13\(^{th}\) August 2009.

\(^{46}\) PBTB, Certificate Document, p.23.

\(^{47}\) *BNM*, ‘Guidelines on Takaful Operational Framework’, p.16
expenses. Yet by referring to the operators’ income statement, it is obvious that the fees are normally insufficient to cover both expenses, even for companies that have recorded huge profits such as Etiqa Takaful Berhad (ETB). In most cases, however, this deficiency leads to a net loss for the companies for that particular financial year. This is especially true for newly established companies such as Sun Life Malaysia Takaful Berhad ([SLTB] formerly known as Commerce Aviva Takaful Berhad - during 2008–2009), PBTB (during 2007–2008) and Hong Leong MSIG Takaful (HLMT-almost every year).

3.1.3.2 Share of Direct Investment Profits (as an Entrepreneur)

In general, it is assumed that every takaful operator will venture into a mudaraba contract with the participants, especially when the latter’s fund is to be invested by the former. In practice, however, the application of this contract is perhaps inevitable in almost every Family Takaful product, since savings are obviously considered an integral part, but may not necessarily be applicable to General Takaful schemes. This is due to the short-term nature of the latter schemes and the absence of a particular savings account (i.e. PIF) for the participants. Yet the application of mudaraba to general products is deemed relevant by some operators in Malaysia such as Syarikat Takaful Malaysia Berhad (STMB) and PBTB, whereby the PRF is invested according to the contract mentioned above. Although this practice appears to be consistent with the AAOIFI’s general guidelines, it is suggested that the standard is meant specifically for Family Takaful lines where the PIF is present. The new guidelines issued by the Central

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50 AAOIFI, Shari’a Standards, p.472, Al-Qarradāghi, p.212.
51 As mentioned earlier, this is due to segregation of the participants’ contribution into two separate accounts in most Family Takaful products, namely (1) The Participants’ Risk Fund (PRF) for tabarru’ purpose, and (2) The Participants’ Investment Fund (PIF) for savings or investment purpose. Obviously the latter account would be invested by the operator via the mudaraba contract.
52 In the Shari’a Standard No. 26 pertaining to Islamic Insurance, it is generally stated that the relationship between the company and the policyholders’ fund is a wakālia relationship in regard to management, and a mudaraba with regards to the investment of the fund’s asset. See AAOIFI, Shari’a Standards, p.472.
Bank appear to concur with this suggestion. Moreover, the fact that most operators do not engage in this kind of practice (i.e. investing the PRF via a *mudaraba* contract) tends to support the above statement.

According to this contract, the amount accumulated in the *takaful* fund (either the PRF or PIF) is invested by the operator as *mudarib*, entrepreneur, in various *Shari’a*-compliant investments. Any profit generated therefrom over and above the original amount of capital is shared according to a pre-agreed ratio. In practice, the profit sharing ratio varies across operators as well as products and can range from 40:60 to 80:20 to the participants and operators respectively. Accordingly, the higher the profit generated from the investment, the larger the amount attributable to the shareholders. However, if the investment is unsuccessful, the operators will not receive anything. In addition, the operators can be held liable for the loss if they are found to be guilty of misconduct or mismanagement. It should be mentioned however, that the definition of *mudaraba* profit as given above has been altered to a certain extent by one particular *takaful* operator, i.e. STMB, who claim to apply a modified *mudaraba* model. Instead of sharing direct investment profit, the company shares the underwriting surplus under the name of *mudaraba* profit. This practice is controversial and will be dealt in other research paper. In a nutshell, it could be suggested that the application of *mudaraba* has marked the commercial feature of *takaful*, since an element of profit-seeking is without a doubt present.

### 3.1.3.3 Performance-Related Charges

Apart from the above two sources of revenue, *takaful* operators may also charge various types of fee contingent upon the achievement of certain desired qualities.

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53 In Section 12 of the guideline, it is stated that an operator could be remunerated from the risk fund (PRF) which exist in both General and Family *Takaful* schemes in the form of performance fees or surplus sharing. On the other hand, the remuneration in the form of share of investment profit (obviously *mudā’inu* profit) shall be earned specifically from managing the investment fund (PIF) for the relevant non-investment-linked Family *Takaful* products. See BNM, ‘Guidelines on *Takaful* Operational Framework’, pp.17-19.

54 STMB applies the profit sharing ratio of 60 : 40 to the company and the participants respectively. PBTB, on the other hand, applies the ratios of 30 : 70 and 20 : 80 to the company and participants respectively.
or output in regard to the management of the takaful undertaking. This performance-related income is obviously variable in nature, as opposed to the fixed wakala charges mentioned earlier. The takaful operators who employ this practice, particularly Takaful Ikhlas Sendirian Berhad (TISB), HSBC Amanah Takaful Sendirian Berhad (HATSB), ETB, SLTB and MATB suggest that it is consistent with the contract of ji’ala, reward for achieving certain desired objectives.\textsuperscript{55} Notwithstanding that, there seems to be no specific reference made to the above contract as far as the written policy documents and guidelines for these operators are concerned.\textsuperscript{56} Basically, the contract of ji’ala ties the reward payment (for the operator) to the actual output and performance of the takaful operations. If the output or performance is short of what is prescribed, the reward will not be due and payable.\textsuperscript{57} This sort of income is argued to be crucial in securing profits for the companies’ shareholders, since the previous two sources are hardly sufficient to cover all the incurred expenses. For example, in the case of ETB, one the most profitable operators in Malaysia, this type of revenue contributed between 42 to 89 per cent of the total gross profit (before zakat and taxation) recorded by the company between 2007 and 2010.\textsuperscript{58}

There are at least two areas or tasks where the contract is said to be relevant/applicable by the respective takaful operators in Malaysia, namely: (1) in investing the participants’ fund (either PRF or PIF) so that a desired level of profit

\textsuperscript{55} Interview with Wan Deraman and Ismail.
\textsuperscript{56} Based on the printed materials gathered from all takaful operators in Malaysia, particularly brochures and policy certificates, there is no indication on the ji’ala contract being applied by these operators. Similarly, in the latest guidelines issued by BNM, no reference has been made to the ji’ala contract despite the guidelines clearly indicate the permissibility of charging performance fee from the risk fund surplus.
is achieved; and (2) in managing the PRF prudently so that an underwriting surplus is attained.

The first task is probably similar to the application of *mudaraba*, as explained earlier. The only difference is that the operator is acting as an investment agent instead of an entrepreneur and will charge a certain percentage (e.g. 10 per cent) of the profit realized as a reward, or to be specific, as an investment performance fee.\(^{59}\) Obviously, the end result of both contracts, particularly the share of investment profit attributable to the shareholders, would be relatively the same. Few operators declare the above charge in investing the PRF, including TISB and CATB. However, by referring to their financial reports, it seems that the above performance-related fees have yet to be implemented by both companies. Conversely, HLMT, despite being silent regarding the above fee, actually charges between 9 to 12 per cent of the PRF investment profit.\(^{60}\)

The application of *ji‘ala* on the second task appears to be more significant, as it tends to justify the sharing of an underwriting surplus from the PRF (by the operator), which is deemed by many to be inappropriate. This is due to the nature of an underwriting surplus, which is commonly viewed as the exclusive property of the policyholders. Since an underwriting surplus is actually derived from the remains of the participants’ contributions (after deducting claims and other related expenses), it is argued to technically and legally belong to the participants as a group.\(^{61}\) Nevertheless, the sharing of PRF surplus by the operator is legally recognized by BNM under the notion of ‘performance fees’, provided that certain

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\(^{59}\) This investment performance charge is normally imposed by the operator who employs the *wakālla ji‘alla* hybrid model. In this particular model, the operator merely acts as a remunerated agent to manage the *takāful* undertaking, for both insurance as well as investment activities. There is no recourse to the contract of *mudāraba* for investing the Fund.


requirements are observed. Some companies, such as TISB, prefer to call this sort of charge a ‘surplus administration charge’. In practice, the operators are seen as applying different surplus sharing ratios which range between 80:20 and 20:80 to the operator and participants respectively. Amongst the operators which have been identified to implement this practice are ETB, TISB, CATB, MATB and HATSB. Due to the controversial nature of this practice, it will be extensively studied in other research paper.

In conclusion, it can be suggested that the categorization of *takaful* as a commercial entity is only limited to the extent of initiating a business organization (which is profit-oriented) to manage and organize insurance schemes which in fact are mutually undertaken by the policyholders under the principle of *tabarru* and *ta’awun*. This is different from commercial insurance in which all insurance activities are undertaken and treated by the insurance company as a pure business endeavour, thus do not necessitate the initial mutual arrangement amongst the insured.

Perhaps the commercialization of *takaful* is unavoidable these days, since it is required by the law of most countries, including Malaysia that the *takaful* operator must be registered and hold a valid licence prior to the commencement of its operation. In general, the licence will only be granted to any organization which fulfils certain requirements, which amongst others include the acquisition of vital skills or experience and a considerable amount of capital to set off the schemes. As a result, one can expect to see most of the licences given to business corporations or public limited companies instead of groups of participants or cooperative bodies. Nevertheless, it is anticipated that the notion of commercialization will gradually lessen in the future, as more co-operative movements will be ready to organize such an undertaking. Until then, it is perhaps

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62 Amongst the requirements are: (1) The performance fee can be taken only if the participants’ portion of the PRF surplus is also paid or accrued to the participants; (2) The total amount of remuneration from PRF payable to the *takaful* operators shall not exceed the amount of surplus paid or accrued to participants (which means that 50 percent is the maximum limit); and (3) There is no outstanding *qard* due to the shareholders’ fund at the point where surplus is determined. See BNM, ‘Guidelines on Takaful Operational Framework’, p.17.
right to say that current *takaful* operators are in fact commercial entities, but (theoretically) within the permitted boundaries and do not have the same characteristics as the forbidden type of commercial insurance.

### 4.0 Conclusion

The categorization of modern *takaful* companies as commercial entities is mainly due to the fact that they are mostly structured as joint-stock or public limited companies, which basically are profit-seeking entities. Nevertheless, this will not necessarily render the *takaful* arrangement similar to conventional insurance, which is forbidden due to its commercial characteristics. One of the key reasons for the above divergence is that the former only acts as a remunerated agent who undertakes to manage and organize all the insurance-related matters on behalf of the policyholders. It is the participants who are actually willing to provide insurance protection amongst themselves under the notion of *tabarru* and *ta`awun*. This is not the case in conventional commercial insurance whereby the insurer takes full responsibility to indemnify the insured in exchange for the premium received in parallel to the contract of sale.

The validity of this commercial type of *takaful* arrangement is perhaps very much dependent upon the specific and correct roles that the operator plays consistent with the application of several specific nominate contracts. In the Malaysian *takaful* environment there appears to be three main contracts widely applied by the *takaful* operators, either in its solitary form or as a combination of two or more contracts, in order to underlie the above relationship as well as to gain profit. These contracts include *wakala bi ajr* (remunerated agency), *mudaraba* (profit-sharing), and *ji`ala* (reward). It is suggested, however, that only if these contracts are correctly and appropriately applied will the subsequent acquired revenue and profits be valid for the commercial *takaful* operator. Otherwise they could possibly be deemed invalid due to their association with *gharar*, *jahala* and other unfair practices.