An Analysis of the Commercial Aspects of Takaful Operation in Malaysia

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ABSTRACT
Many Muslim scholars maintain that the commercial insurance contract is invalid from the Shari’ah perspective based on the fact that it is a financial exchange contract, which is overwhelmed by banned elements such as gharar, riba, and maysir. Alternatively, a Shari’ah-compliant insurance scheme, known as takaful, was introduced in the late 1970s that supposedly operate on the principles of mutual cooperation. Nonetheless, since the majority of existing initiators of this lawful scheme are mainly joint-stock or public limited companies, it seems that the initial concept of takaful was later overshadowed by the element of profit-making 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 model 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, mudarabah, ji’alah, wakalah, tabarru’.

INTRODUCTION
Efforts towards the establishment of Shari’ah-compliant insurance providers have been initiated since the early 20th century, concurrent with a series of fatwa (legal rulings) issued on the impermissibility of commercial insurance as well as the legitimacy of mutual or co-operative insurance. In fact, the latter fatwa tend to reflect the vision of Muslim scholars to see the establishment of Islamic insurance providers based on the mutual or co-operative principle. Despite the fact that the above fatwa have been issued since as early as 1961, the institutionalization of Islamic insurance based on the above principle only materialized in the late 1970s (al-Qarradaghi, 2005). Yet, recent development tends to show that modern takaful arrangement may differ from mutual or co-operative principle. While the insurance fund in a mutual or co-operative entity is completely owned and managed by its own members, a takaful fund, on the other hand, can possibly be managed by a joint-stock commercial entity (whilst its ownership maintains with the participants) (IFSB, 2009). 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. As a result, takaful could be well described as a hybrid of a 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 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. Before a thorough analysis can be conducted with regards to the above issue, it is crucial at the very outset to define the meaning of commercialization.

The Meaning 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 (Allen, 1990). 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) (Rooney and Jellis, 2005). When a particular organization or activity is labeled 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 (Collins, 2004).

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. If something is commercialized, it is used or changed in such a way that it makes money or profit, often in a way that people disapprove of (Collins, 2004). It also means to apply business principles to something or run it as a business and to exploit something for financial gain (Rooney and Jellis, 2005). 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 article, takaful is considered to be greatly affected by the notion of commercialization, since most of the current 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 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 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 takaful companies currently operating, only one appears to be jointly owned by a co-operative body (Noordin, 2012). Nevertheless, as will be explained next, this may not necessarily render the 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 gharar incidences can be detected in the operation of certain operators that might render the commercial side of takaful invalid (Noordin, 2012).

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.

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 (AAOIFI, 2007). 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 or entrepreneur to the takaful arrangement, but not as an insurer (al-Qarradaghi, 2005). 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 tabarru’ and ta’awun (AAOIFI, 2007). 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 mu’awada, it is obviously underlain by several contracts other than sale, i.e. wakala bi ajr, mudaraba or ji’ala.

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 (IFSB, 2009, AAOIFI, 2007). 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), 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 (AAOIFI, 2007). 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 wakala charges, and in some cases may also include performance 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 (Ma’sum Billah, 2007, al-Qarradaghi, 2005). 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.

**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 (AAOIFI, 2007). 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 (Ismail and Abdul Razak, 2009). 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.

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 (al-Qarradaghi, 2005, AAOIFI, 2007). 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 1st October 2011, the following requirements need to be observed by takaful operators in determining the appropriate amount of the above incomes (BNM, 2011):

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.
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 (Noordin, 2012). In contrast to this general fee, some companies, such as PrudentialBSN 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 (PBTB, 2011). 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 (BNM, 2011).

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 then 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 expenses (Mohd. Kassim, 2007). 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 financial year, PBTB (during 2007–2008) and Hong Leong MSIG Takaful (HLMT) in almost every year.

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 (al- Qarradaghi, 2005). 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 (Noordin, 2012). This is due to the short-term nature of the latter schemes and the absence of a particular savings account (i.e. Participant’s Investment Account or 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 Bank appear to concur with this suggestion (BNM, 2011). 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 (Noordin, 2012). 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.

**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 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 (Noordin, 2012). 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. 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 (Engku Ali and Odierno, 2008). 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 (Etiqa 2008, 2010).

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 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 (TISB, 2011). 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 SLTB. 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 (HLMT, 2008, 2011).

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 (Ayub, 2007 and Arbouna, 2008). Nevertheless, the sharing of PRF surplus by the operator is legally recognized by BNM under the notion of ‘performance fees’, provided that certain requirements are observed (BNM, 2011). 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 50:50 to the operator and participants respectively (Noordin, 2012). Amongst the operators which have been identified to implement this practice are ETB, TISB, SLTB, 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 co-operative 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 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.

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 dependant 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.

REFERENCES