Investigating the Impact of Commercial Dimension on Islamic Insurance

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Many Muslim scholars are of the view that insurance contract is invalid from the Shari`a perspective because it is an exchange contract overwhelmed with prohibited elements such as gharar (uncertainty), riba (interest) and maysir (gambling). Alternatively, a Shari`a-compliant insurance, also known as *takaful*, was introduced in the late 1970s that supposedly operating based on the principles of mutual co-operation. Since the majority of existing insurance and *takaful* companies are mainly joint-stock or public limited companies, it seems that the concept of *takaful* that was proposed earlier is now overshadowed by the element of profit-making as observed in other insurance entities. This paper sets out to investigate issues related to the structure of *takaful* company and its commercialisation aspect by examining various reports and documents as well as undertaking fieldwork study. Although there is no structural difference between *takaful* and insurance company, we find that *takaful* company should employ appropriate contracts so that its revenue and earnings have no association with elements that are prohibited in Islam.

INTRODUCTION

Efforts towards the establishment of *Shari`a*-compliant insurance 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, recent *fatwas* tend to reflect the vision of Muslim scholars to see the establishment of Islamic insurance services should be based on the mutual or co-operative principle. Despite the fact that the above *fatwas* have been issued as early as 1961, the institutionalization of Islamic insurance based on the proposed principle only materialized in the late 1970s (al-Qarradaghi, 2005).

Yet, recent development tends to show that modern *takaful* structure may differ from mutual or co-operative entity. While the insurance fund in a mutual or co-operative entity is completely owned and managed by its own members, the modern *takaful* fund can possibly be managed by a joint-stock commercial entity, whereas its ownership maintains with the participants (Islamic Financial Services Board, 2009). Based on this feature, *takaful* may not necessarily be restricted to a purely mutual in structure but could also be set-up as a commercial. In other words, the company that manages the takaful fund (i.e. the *takaful* operator) is actively seeking profits by charging certain fees payable 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 relationship.

The Commercialization of *Takaful*:

As previously stated, the majority of the *takaful* companies available today are initiated by their shareholders and structured as joint-stock either private or public limited companies rather than purely mutual organizations. Thus, it is perhaps plausible 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 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 & Jellis, 2005). 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 (Collins Advanced Learner’s English Dictionary, 2004).

‘Commercialize’ is a verb which means to manage or exploit (an organization, activity, etc.) in a way designed to make a profit, often in a way that people disapprove of (Collins Advanced Learner’s English Dictionary, 2004). It also means to apply business principles or exploit it for financial gain (Rooney & 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 or to adopt any means possible in order to achieve the objective.

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/installing management services rather than 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 Noordin (2012) that all the takaful schemes in Malaysia are initiated, marketed and organized by commercial organizations which are backed by leading financial giants. Of all the 12 takaful companies currently operating, only one appears to be jointly owned by a co-operative body. Nevertheless, this may not necessarily render the takaful arrangement similar to commercial insurance, which is considered forbidden by the majority of Muslim scholars. 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 from the services rendered. 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 and avoids 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. As for the takaful operator or company, its revenue and profit should only be sought through legitimate or Shari’a-compliant means, which are supposed to be free from the 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 takaful 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 Shari’a-complied 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 follow in the next sections.
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 (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 *takaful* 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 members of *takaful* participants that is actually considered to be the insurer (as well as the insured) in this structure, 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 underlined by several contracts other than sale, i.e. *wakala bi ajr, mudaraba* or *ji'ala*.

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 (AAOIFI, 2007; Islamic Financial Services Board, 2009). In specific, all contributions paid by *takaful* 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 *takaful* company, or to be specific, the shareholders, has no rights to the money credited to or remained 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 insurance to hold two different accounts, since all premiums collected are immediately owned by the insurance company in exchange for its insurance protection and insurance holders have no control of the fund management (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) belong to the shareholders, and not the insurance holders.

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 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 & Abdul Razak, 2009). Besides, an insurance company may earn profit from investing its own capital as well as the above premiums in various fields including the prohibited businesses.

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, profits earned in the PRF cannot be regarded as the shareholders’ profit. Instead, it remains the property of the policyholders as a group, and could partly or wholly be distributed between policyholders and *takaful* operator based on surplus-sharing (al-Qarradaghi, 2005; AAOIFI, 2007). Nonetheless, a *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 either in the form of fees and charges imposed on contributions and the PRF or in the form of profit-sharing of the fund, which corresponds to the application of several specific contracts that underlie the relationship between the PRF and the operator. In the latest guidelines issued by Bank Negara Malaysia, 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 (Bank Negara Malaysia, 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 sources of 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. This upper limit is regulated by Bank Negara Malaysia though the specific guidelines pertaining to this rule could not be found by Noordin (Noordin, 2012). In contrast to this general fee, some takaful 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 (PBTB, 2011). Another takaful 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’ 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 (Bank Negara Malaysia, 2011).

From these charges, the shareholders’ account may earn some profits (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 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 Insurance 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 Berhad (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 fund is to be invested by the takaful operator (al-Qarradaghi, 2005). In practice, unlike general takaful, however, the application of this contract is perhaps inevitable in almost every Family Takaful product, since savings are obviously considered an integral part (Noordin, 2012). This is due to the nature of risk in general takaful as well as the absence of participants’ savings account in it (i.e. Participant’s Investment Account or PIF). Yet the application of mudaraba in 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 where the PIF is present. The new guidelines issued by the Central Bank appear to concur with this suggestion (Bank Negara Malaysia, 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 mudaraba contract, the amount accumulated in the takaful fund (either the PRF or PIF) is invested by the takaful 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 takaful 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 takes a cut in 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 undoubtfully 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 obviously varies 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).

Nonetheless, 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 neither be due nor payable (Engku Alwi & Odiero, 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 operating expenses. For example, in the case of ETB, one of the most profitable operators in Malaysia, this type of revenue contributed between 42 to 89 per cent of the total gross profit recorded by the company between 2007 and 2010 (Etiqa Insurance Berhad, 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 (Takaful Ikhlas Sendirian Berhad, 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, the financial reports of TISB and SLTB show that the above performance-related fees have yet to be implemented by both companies. Meanwhile HLMT, despite being silent regarding the above fee, actually charges between 9 to 12 per cent of the PRF investment profit (Hong Leong MSIG Takaful Berhad, 2008, 2010).

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 takaful 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 participants’ contributions, it is argued technically and legally that it belongs to the participants (Ayub, 2007; Arbouna, 2008). Nevertheless, the sharing of PRF surplus by the operator is legally recognized by Bank Negara Malaysia under the notion of ‘performance fees’, provided that certain requirements are observed (Bank Negara Malaysia, 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 takaful 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 papers.

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 ta`awun and tabarru` and ta’avun. 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.

Conclusion:

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 license will only be granted to any organization which fulfills certain requirements, which amongst others include the acquisition of vital skills or experience and considerable amount of capital to operate the schemes. As a result, one can expect to see most of the licences are 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.

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 structure similar to conventional insurance, which is
forbidden due to its commercial characteristics. One of the key reasons for the above divergence is that *takaful* operator only acts as a remunerated agent who to manage and operate the insurance 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 shareholders of the insurance company take full responsibility to indemnify the insured in exchange for the premium received in parallel to the contract of sale.

We have shown that the structure of *takaful* companies has led to the commercialization of *takaful* operation. As the shareholders’ own the *takaful* companies and at the same time the *takaful* companies also manage the *takaful* participants’ fund, it is inevitable that there is conflict of interest among shareholders, *takaful* operators and *takaful* participants. As the backbone of the company, shareholders demand profit and it is the incentive for the shareholders to initiate a business (Jensen & Meckling, 1972). We have also shown that the structure of *takaful* has effect on the operation of *takaful* participants’ fund. Essentially, shareholders want to have a bigger profit-share such that some Shari’a contracts are not fully complied or clearly disclosed. This is the negative effect of commercialization of *takaful* operation.

The validity of this commercial type of *takaful* structure 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 Malaysia 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 ajar* (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


