SURPLUS-SHARING PRACTICES OF TAKÁFUL OPERATORS IN MALAYSIA

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Izwayu Abdul Aziz**
Noraziyah Md. Hilal***

Abstract

In takáful (Islamic insurance), surplus in the takáful fund will emerge when the overall operations of the fund perform better than expected, i.e. when the underwriting, investment and expense management yield favourable results. Surplus, in general, refers to the excess amount of contributions available in the takáful fund after taking into account total claims paid, amount payable for retakáful contributions, reserves allocated and investment profits accrued to the fund. Given the rightful roles of takáful operators as ‘managers’ of the takáful fund and participants as owners of the fund, this paper discusses the current practice of surplus management and distribution, including the application of the surplus-sharing concept, among takáful operators in Malaysia. The study combines both qualitative and quantitative research methods and relies greatly upon availability of disclosures on the surplus distribution practice by takáful operators. The paper also sets out to establish the effectiveness of the existing practice in promoting a strong and sustainable takáful fund, upholding participants’ stature as owners of the takáful fund and enticing consumers to participate in takáful, as well as identifying the areas within the practice that can be improved to further enhance the

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feature and value proposition of surplus in takāfol. The study affirms that, in actual practice, the surplus generated from the takāfol fund is distributed between participants and takāfol operators, with variation seen from the perspectives of frequency of distribution, method of distribution and specific Shari’ah contracts used to underlie the distribution. Several improvements on the disclosures of information on surplus are also suggested in the paper.

Keywords: Takāfol, Surplus sharing, Islamic finance.

I. INTRODUCTION

Takāful is derived from an Arabic word which means ‘joint guarantee’ (Bank Negara Malaysia, 2004: 2). Premised on the key principles of tabarru (donation) and ta‘awun (mutual cooperation), takāful pools the contributions from the takāful participants for the mutual indemnification of losses among its members. The scope of events and/or risks covered in a takāful arrangement is pre-agreed collectively by the participants.

The element of mutuality in takāful is embedded in the legislation, regulatory frameworks and international standards on takāful. In Malaysia, the Islamic Financial Services Act 2013 (IFSA) defined takāful as:

An arrangement based on mutual assistance under which takāful participants agree to contribute to a common fund providing for mutual financial benefits payable to the takāful participants or their beneficiaries on the occurrence of pre-agreed events (Bank Negara Malaysia, 2013: 36).

The Islamic Financial Services Board (IFSB) (2009) also recognised the sense of solidarity in takāful and mutual cooperation among the participants of a takāful pool. In IFSB-8: Guiding Principles on Governance for Takāful (Islamic Insurance) Undertakings, the IFSB emphasised the underlying arrangement in which takāful’s mutuality is rooted:
A participant contributes a sum of money as *tabarru‘* commitment that will be used to assist members against a specified loss or damage (IFSB, 2009: 27).

The abovementioned underlying principles of *takāful* make it clear that the stature of *takāful* participants in a *takāful* arrangement is fundamentally different from that of policyholders in conventional insurance. In a commercially-run *takāful* arrangement, the *takāful* participants are the ones bearing the risks; the *takāful* operator merely acts as the manager of the *takāful* fund where risks and contributions are pooled (Saaty & Ansari, n.d.). In contrast, in a conventional insurance arrangement, the risks insured for the policyholders are assumed by the insurance company. The participants’ collective and mutual ownership of the *takāful* fund is a distinguishing feature of *takāful* that is upheld throughout the *takāful* operation. It is on this unique basis that another distinctive feature prevails in *takāful* products—namely, the distribution of the *takāful* fund surplus back to the participants.

Issues surrounding the surplus in *takāful* operations have often been debated at various forums. The issues relate to its ownership, overall management of surplus in the *takāful* fund, its distribution to participants and/or *takāful* operators and the consistency of such distribution with the contracts used in the model adopted by the *takāful* operator (Fisher & Taylor, 2000; Khairat, 2010, 2014). This paper will not focus on the need for harmonisation of the practice of surplus management and distribution. Instead, it will examine the current practice of surplus management and distribution by *takāful* operators in Malaysia, which is premised on the ruling of the Shariah Advisory Council (SAC) of Bank Negara Malaysia (BNM), and it will identify the areas within the practice that can be improved to further enhance the feature of surplus in *takāful*. For the purpose of clarity, ‘surplus’ referred to in this study includes income generated from investments of the participants’ contributions pooled in the *takāful* fund, in addition to the excess in the *takāful* fund after meeting its obligations due within a specified period.
This paper attempts to achieve the following objectives:

- To analyse various practices of surplus management in takāful business, including the application of the surplus-sharing concept among takāful operators;
- To identify areas of takāful operations that can be improved to enhance the value proposition of surplus in takāful.

Towards achieving the objectives outlined above, this paper seeks to address the following questions:

- What are takāful operators’ experiences regarding surplus and their surplus distribution practices? Do they vary by product or takāful fund?
  - What are the eligibility criteria for participants in receiving surplus distribution?
  - How and when is surplus distributed to participants?

- How effective are the existing practices on surplus management in:
  - Promoting a strong and sustainable takāful fund?
  - Reflecting participants’ collective ownership of the takāful fund?
  - Aligning the interests of various stakeholders?

- How can the practice of surplus sharing be enhanced in order to increase the marketability of takāful?

This paper comprises four sections. After the Introduction, Section II discusses the concept of surplus and its management. Section III presents the observation and findings from the practice of surplus management by takāful operators in Malaysia. Section IV outlines the conclusion and recommendations arising from the findings of the study.

II. SURPLUS MANAGEMENT IN TAKĀFUL OPERATIONS

This section discusses the concept of surplus in takāful vis-à-vis its application in conventional insurance as well as the Sharī‘ah and regulatory perspectives on surplus upon which market practice surrounding surplus management in Malaysia is based.
a. Overview of Surplus

The benefits of *takāful* extend beyond assisting fellow participants upon occurrence of unfortunate events. Upon meeting certain predefined terms and conditions, participants can be ‘rewarded’ with additional benefits which come in the form of surplus distribution. Put simply, surplus refers to the remaining balance in the *takāful* fund (at the end of a financial year), taking into account contributions collected from participants and income generated from investing them, and the obligations due to be settled, e.g., payment of claims and/or benefits, costs of *retakāful* (reinsurance) and other relevant expenses.

There are various international standards, regulatory frameworks and other literature that depict the components of surplus as guidance for industry practitioners, some of which are provided below.

The IFSB (2010: 25), in its *Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings* defined underwriting surplus or deficit as:

> The Participants’ Risk Fund’s financial outturn from the risk elements of its business, being the balance after deducting expenses and claims (including any movement in provisions for outstanding claims) from the contribution income and adding the investment returns (income and gains on investment assets).

AAOIFI (2010), in its Financial Accounting Standards No. 13, on *Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies* made reference to underwriting surplus as:

> The excess of the total contributions paid by policyholders during a financial period over the total indemnities paid in respect of claims incurred during the period, net of reinsurance and after deducting expenses and charges in technical provisions (as cited in Hidayat, 2012: 3).
Based on the definitions provided earlier, one notable difference on what constitutes ‘underwriting surplus’ is the inclusion or exclusion of income made from investing the participants’ contributions. To complement the guidance provided above on the components of surplus, regulators may provide specific definitions for surplus, factoring in the industry’s best practices and other requirements such as accounting, with respect to the specific inflow and outflow of monies to be considered by takāful operators of particular jurisdictions when determining surplus, such as allocation of money for contingency reserve. Some takāful operators also provide the definition of surplus (or relevant components of surplus) to the public, infusing the guidance provided by regulatory frameworks and/or international standards within their own business model. For example, in its financial statements 2013, Takaful Ikhas Berhad (2013: 35) identified their ‘surplus administration charge’ as one of the costs to be reckoned in determining the surplus distributable to the participants:

Surplus as determined after deducting benefits paid and payable, retakāful, provisions, reserves, wakālah fees, taxation and surplus administration charge transferred to the shareholder’s fund.

b. Surplus Management in Takāful

Since the emergence of surplus in the takāful fund is dependent on the overall operations of the fund—namely, the pricing of the contributions, selection of participants for underwriting, provisioning of retakāful and reserves—it is essential for the takāful operator to ensure that each operation is carried out effectively and with a reasonable degree of prudence. As the one entrusted to manage the takāful fund, the takāful operator is expected to pay due attention to the overall management of the takāful fund, including the surplus. Surplus management is certainly not a simple task as the takāful operator is expected to balance the need to ensure the long-term sustainability of the takāful fund (i.e. retaining sufficient surplus to strengthen the takāful fund) and the need to fulfil reasonable expectations of the participants (on receiving the surplus share). The takāful operator is also expected to consider the long-term products (such as family
takāful products) as well as the long-tailed nature of certain takāful products where liabilities to pay out takāful benefits for such products may extend into future years (such as those involving litigation or other legal processes which are time consuming) (Odierno, 2008). It is thus important to ensure that the entire spectrum of surplus management, which includes the determination, allocation and distribution of surplus, is managed in a reasonably prudent manner to ensure that the interests of the takāful fund, participants and other relevant stakeholders are safeguarded.

c. Comparison with Participating Policies of Conventional Insurance

Distributing a portion of the fund’s balance or surplus is not a new concept in the insurance sphere. The concept of distributing surplus is also practiced in ‘participating policies’ of conventional insurance, albeit grounded on different principles. In a participating insurance policy, the participating insurance fund belongs to the insurance company, and the policyholders are merely given the rights to share in the profits made by the fund. The profits are usually distributed in the form of bonuses and/or cash dividends.

The focal point that differentiates the stature of surplus in takāful from that in a participating insurance policy is the ownership of the takāful/insurance fund itself. In takāful, the takāful funds are owned collectively by participants, and surplus distribution is one of the takāful benefits that can be collectively agreed upon by the participants. Agreement on how surplus is to be distributed is explicitly included in the takāful contract.

Before proceeding in greater depth on surplus management and distribution practices by takāful operators, it is important to understand the arguments and principles that have shaped the background of the market practice in Malaysia.

d. Fiqh Views on Surplus Distribution in Takāful

There have been long debates on the rightful practice of surplus distribution from the Sharī‘ah perspective. In general, three main juristic views surfaced within the takāful industry on the subject of surplus distribution. The first view contests the distribution of surplus
in totality, as such the practice is deemed as going against the basic aim of pooling the takāful contributions (Billah, 2007). Under the concept of donation, participants contribute to the takāful fund with the pure intention of helping fellow participants when a predefined misfortune occurs. As such, the participants should not expect any economic return. Surplus distribution to the participants is deemed by certain scholars as contradicting the intention of tabarru‘, i.e., relinquishment of one’s right over the contribution (Billah, 2007).

The second view is that sharing the surplus with the takāful operator is prohibited. This is premised on the argument that the participants have exclusive ownership rights to the takāful fund. Certain scholars contend that since the takāful operator is not a contributor to the takāful fund, it should not be entitled to any portion of the fund (Noordin, n.d.).

The third view is that the sharing of surplus between the participants and the takāful operator is permissible, justifying the surplus shared with the takāful operator as a reward for effective management of the takāful fund (BNM, 2010).

Despite these differing views, the majority of takāful markets around the world have allowed surplus to be distributed and shared between participants and takāful operators, e.g., Bahrain, Qatar, Pakistan, and Jordan. In Malaysia, the Shariah Advisory Council of Bank Negara Malaysia (the SAC), in its 42nd meeting dated 25 March 2004 and 59th meeting dated 25 May 2006, resolved that the surplus distribution is permitted to both the participants and the takāful operators. For a takāful arrangement that is based on the wakālah model, the surplus distribution to the takāful operator is considered as a performance fee in return for the takāful operator’s role as the manager of the takāful fund. For a takāful arrangement that is based on the mudārakah model, the surplus distribution to both the takāful operator and the participants would be in accordance with an agreed sharing ratio (BNM, 2010). In its resolution, the SAC further stressed the importance of having the method of surplus distribution clearly mentioned and agreed upon by the participants during the conclusion of the takāful contract. This resolution reflects the importance of the participants’ agreement to surplus management of the takāful fund and is clearly consistent with the participants’ stature as owners of the takāful fund.
e. Governance on Surplus Management in Malaysia

In Malaysia, IFSA 2013 provides dedicated provisions that focus on the prudent management of the takāful fund and its surplus, particularly on its withdrawal from the takāful fund. IFSA 2013 also empowers Bank Negara Malaysia as the regulator to specify policies on the governance and management of takāful operators for the whole takāful operation. The Appointed Actuary (a statutory role under IFSA 2013) is responsible, among others, for making a suitable recommendation for surplus distribution. The Board of Directors of the takāful operator, supported by its senior management, are entrusted to oversee the management of surplus (including deciding on the actual amount of surplus to be distributed based on the Appointed Actuary’s recommendation).

In 2010, Bank Negara Malaysia issued the Guidelines on Takaful Operational Framework (TOF), which has specific sections governing the management of surplus, determination of surplus and its distribution. According to the TOF, which was made effective on 1 January 2012, takāful operators are required to establish their own internal policy on the management of surplus, approved by the Sharī‘ah Committee and the Board of Directors. The policy must be in compliance with Sharī‘ah principles underlying the operational model(s) adopted by takāful operators, and inclusive of requirements on utilisation of surplus, i.e., distribution of surplus to eligible recipients as well as level of surplus to be retained to safeguard the takāful fund against future volatilities. One of the most striking policies on surplus introduced in the TOF is the prominence given to participants with respect to surplus distribution. The TOF prioritises distribution of surplus to participants, in recognition of their ownership of the takāful fund, such that the takāful operator cannot receive more than the participants’ share of the surplus. The guiding principles and parameters of the TOF are summarised in Figure 1. Figure 2, on the other hand, summarises the main parties who are involved in takāful operators’ surplus management.
Similar regulatory requirements on surplus management are noted to be adopted by regulatory authorities in other jurisdictions, in particular on the need for takāful operators to have their own internal policy on surplus management, the parties to be held responsible in surplus management as well as the requisites under which surplus distribution could be allowed or otherwise. These regulatory requirements are summarised in Table 1.
## Table 1: Requirements on Surplus Management by Other Regulatory Authorities

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Regulator</th>
<th>Stance</th>
</tr>
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<tbody>
<tr>
<td>Bahrain</td>
<td>Central Bank of Bahrain</td>
<td>• Each <em>takāful</em> firm must have an internal written policy in determining surplus or deficit arising from <em>takāful</em> operations, the basis of surplus/deficit allocation and method of transferring it to participants.</td>
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<tr>
<td></td>
<td></td>
<td>• The policy must consider relevant AAOIFI standards and be endorsed by the firm’s Shari‘ah Supervisory Board and the Board of Directors.</td>
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<tr>
<td></td>
<td></td>
<td>• The policy must not be amended or changed without the Shari‘ah Supervisory Board’s approval.</td>
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<td></td>
<td>• The surplus distribution or remedial action for deficit reduction must be recommended by the Actuary, endorsed by the firm’s Shari‘ah Supervisory Board and the Board of Directors.</td>
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<tr>
<td></td>
<td></td>
<td>• Surplus distribution is subject to the Central Bank of Bahrain’s prior approval.</td>
</tr>
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<td></td>
<td></td>
<td>▪ Surplus distribution is not permitted if it would result in the firm not meeting its capital and solvency requirement.</td>
</tr>
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<td></td>
<td></td>
<td>▪ The surplus distribution must not cause adverse financial implications or deficit in the participants’ fund.</td>
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<tr>
<td>Pakistan</td>
<td>Securities and Exchange Commission of Pakistan</td>
<td>• The surplus/deficit shall be determined by Appointed Actuary for family <em>takāful</em> operator and the Management for general <em>takāful</em> operator, at the end of each financial year.</td>
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<tr>
<td></td>
<td></td>
<td>• Any surplus must be distributed amongst participants in proportion to their contributions to the Participant <em>Takāful</em> Fund net of any claims payout which may have been received during the period.</td>
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<td></td>
<td></td>
<td>• <em>Takāful</em> operator may compute the distributable surpluses based on combined results of all classes of business or separate results for each class.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• The Board of Directors, with the consent of the <em>takāful</em> operator’s Shari‘ah Advisor, must set out detailed mechanism for surplus distribution and its frequency.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• The method and frequency of surplus distribution must form part of the Participant <em>Takāful</em> Fund’s policy.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• <em>Takāful</em> operator may distribute surplus either in cash, adjust the payment against future contributions or transfer to Participant Investment Fund as additional investment.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• A participant may donate his/her surplus for social or charitable purposes and may request the <em>takāful</em> operator to arrange for the transfer of the donation.</td>
</tr>
</tbody>
</table>
Jurisdiction | Regulator | Stance
--- | --- | ---
Qatar | Qatar Financial Centre Regulatory Authority | • Each *takāful* firm must have an internal written policy for determining surplus or deficit arising from *takāful* operations, the basis of surplus/deficit allocation and method of transferring it to participants.
• The policy must comply with relevant AAOIFI standards and be endorsed by the *takāful* entity’s Shari’ah Supervisory Board.
• A copy of the policy must be provided to the Regulatory Authority.
• All distributions of profit or surplus made to policyholders must be reported to the Regulatory Authority within 15 business days of the declaration date.
• *Takāful* entity must not make any distributions to participants if it would result in the entity not meeting its minimum capital requirement.


III. OBSERVATION AND FINDINGS ON *TAKĀFUL* OPERATORS’ POLICIES AND PRACTICES ON SURPLUS MANAGEMENT AND ITS DISTRIBUTION

*a. Background Information on the Malaysian Takāful Market*

This section will look into market practice of *takāful* operators in Malaysia regarding surplus management, particularly its distribution. Currently, eight (8) composite *takāful* operators are permitted to conduct both general and family *takāful* businesses, while three (3) other *takāful* operators are licensed to conduct only family *takāful* business. The majority of the *takāful* operators are young companies; only three (3) players have been operating for more than ten (10) years. Five (5) of the other *takāful* operators have been operating from five (5) to ten (10) years, and three (3) of them have only been in existence for less than five (5) years.

The SAC and Bank Negara Malaysia’s rulings and requirements with regard to surplus have notably led to the changes made by *takāful* operators in their business models. This is evidenced particularly in two (2) areas related to surplus distribution: the eligible recipients, and the ratios of surplus to be shared between the eligible recipients. Prior to 1 January 2012 (before implementation of the TOF), the ratios of
surplus distributable to participants and *takaful* operator varied across *takaful* operators and product lines. The ratios (participants:*takaful* operator) were as high as 90:10 and as low as 20:80. With the implementation of the TOF, *takaful* operators’ practices on surplus are changing. Currently all *takaful* operators are applying surplus sharing as part of their business model. The operators have also maximised their share of the surplus to the full allowable limit, as observed by the convergence of the varying surplus-sharing ratios to 50:50. This is true even for those *takaful* operators who previously enjoyed a much lower share of surplus. Figure 3 shows the ratios of the distribution adopted by the *takaful* operators prior to 1 January 2012 and after that date.

**Figure 3: Varying Ratios for Surplus Distribution as Practised by Takaful Operators – Prior to and Post 1 January 2012**

Guided by the principles and parameters set out in the TOF, *takaful* operators further set their internal policies on surplus management, which involved the common areas identified in Figure 4. Notably, *takaful* operators exhibited transparency in their approaches towards surplus management to the public, though at varying levels of detail. Some *takaful* operators documented their approaches and policies on surplus distribution in their financial statements, company websites, and other places whilst others limited it only to the financial statements and product marketing materials. Certain *takaful* operators also outlined the policies in great detail, providing certainty and transparency concerning their stance on surplus management. Such approaches of varying disclosure to the public are seen to allow some
flexibility for takāful operators to manage expectations from the public, in particular potential participants, regarding their entitlement to the surplus to be distributed.

Figure 4: Common Areas Adopted by Takāful Operators in their Internal Policies on Surplus Management and Distribution

Source: Bank Negara Malaysia

b. Takāful Operators’ Experiences Regarding Surplus for Financial Years 2009–2014

The amount of surplus arising in any particular year would reflect the underwriting and investment experience of the takāful fund, i.e., the surplus can result from better-than-expected experience in claims, lapse in the coverage, any changes in valuation basis as well as investment. All of these permutations involve the setting of assumptions by takāful operators when pricing a takāful product. Even though setting highly conservative assumptions may likely result in surplus emerging, takāful operators would ideally set the assumptions with a reasonable degree of prudence so as to balance the competitiveness of the takāful products (as conservative assumptions would lead to higher contribution amounts). The following analysis focuses on the takāful operators’ experiences regarding surplus without deliberating on the suitability of the assumptions made during the pricing of takāful products. It is mainly based upon information
collated on the financial year end basis for general *takāful* and family *takāful* funds—namely, the ‘surplus approved for distribution to participants and shareholders (SA)’ and the ‘net earned contributions (NEC)’. For the purpose of consistency, shareholders will be referred to as the *takāful* operators in this section.

### i. General *Takāful* Fund

(a) Trend of Surplus Approved for Distribution for 2009-2014

The industry’s total surplus approved for distribution to participants and *takāful* operators seemed volatile during the period 2009-2014, predominantly influenced by the performance of general *takāful* funds of a few *takāful* operators. Judging from the trend of surplus approved for distribution by individual *takāful* operators, three (3) major categories of *takāful* operators can be seen: *takāful* operators that have consistently distributed surplus, *takāful* operators that have distributed surplus only in recent years and *takāful* operators that have yet to generate enough surplus for distribution.
Chart 2 depicts the average amount of surplus approved for distribution by takāful operators that have been operating for (i) more than ten (10) years and (ii) less than ten (10) years. Takāful operators that have been operating for more than ten (10) years are noted to have been able to maintain their favourable surplus positions throughout the period. There is a strong correlation between the amounts of surplus approved for distribution for the year with the period of the operation, as shown in Table 2 below. This observed phenomenon is reasonable given the size of the general takāful funds managed by these takāful operators, which are larger than those of other takāful operators. The amount of gross contributions for general takāful funds of these takāful operators is more than RM1 billion as at 2014, covering various classes of risks. The cross-subsidisation of these multiple risk classes enables the takāful operators, to a certain extent, to ‘smoothen’ the underwriting experience of the takāful fund, thereby producing surplus for distribution.

<table>
<thead>
<tr>
<th>Year</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>CORRELATION</td>
<td>0.96</td>
<td>0.98</td>
<td>0.97</td>
<td>0.97</td>
<td>0.7</td>
<td>0.76</td>
</tr>
</tbody>
</table>
(b) *Takāful* Operators’ Surplus Position Computed Against Net Earned Contribution

Data on the \( SA \) for the year is computed against the *takāful* operators’ \( NEC \) as a measure to reflect comparable level of surplus of *takāful* funds for the year.

\[
y, \text{ as a measure of } takāful \\
\text{funds’ level of surplus for the year} = \frac{\text{Total } SA}{\text{NEC}} \times 100
\]

Chart 3 shows the surplus positions (represented by \( Y_s \)) for 2013 of all *takāful* operators that conduct general *takāful* business, which are noted to be within the range of -14.2% and 62.6% of their individual net earned contribution. This depicts that for every RM100 net contribution earned by each *takāful* operator for its general *takāful* business, the surplus distributable/deficit originated is between (RM14.20) and RM62.60.

![Chart 3: Surplus Approved for Distribution as % of Net Earned Contribution for 2013](image)

The results are further analysed in an attempt to establish the links between the *takāful* operators’ *number of years in operation* with the *level of surplus approved for distribution for the year* (\( SA \) as the % of \( NEC \)) within the *takāful* operators’ general *takāful* fund.
Surplus-Sharing Practices of *Takāful* Operators in Malaysia

*Takāful* operators that conduct general *takāful* business are grouped in two (2) categories based on the number of years of operation: (i) *takāful* operators which have been in operation for more than ten (10) years; and (ii) *takāful* operators which have been in operation between five (5) and ten (10) years. Based on results in 2013, *takāful* operators in category (i) stand out as having a relatively stable level of surplus for the year, with the value ranging from 26.3% to 31.6%. However, for *takāful* operators in category (ii), there appears to be no direct linkage between the individual *takāful* operator’s length of operation and the surplus position.

A similar trend is observed when the statistics for 2009–2013 are compared, as shown in Chart 4 below. Judging by the average ratio of SA/NEC for the two categories of operators during this period, *takāful* operators in category (i) appeared to have better and more stable average SA/NEC ratios (ranging from 20.6% to 31.5%), as compared to the *takāful* operators in category (ii). This suggests that the ability of these *takāful* operators to leverage on their fund’s size and degree of cross-subsidisation of multiple risk classes, and to draw down from the surplus retained in the *takāful* fund from previous years, has enabled them to stabilise the amount of surplus declared for distribution to participants and shareholders. *Takāful* operators with less number of years in operation may need additional time to build a sizeable fund in order to have smoother results.

*Chart 4: Average of the Surplus Approved for Distribution as % of Net Earned Contribution for 2009–2013*
A simple correlation test also suggests that there is a weak linkage, if none at all, between the two.

Table 3: Correlation Test Result for Linkage between Takāful Operator’s Length of Operation to Surplus Position as % of Net Earned Contribution for 2009–2013

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>CORRELATION</td>
<td>0.7</td>
<td>0.59</td>
<td>0.34</td>
<td>0.02</td>
</tr>
</tbody>
</table>

**ii. Family Takāful Fund**

(a) Trend of surplus approved for distribution for 2011–2014

As shown in Chart 5 above, the industry’s total surplus approved for distribution to participants and takāful operators showed an undulate trend from 2011 until 2014, with an increasing number of takāful operators able to distribute surplus over the period concerned. Similar to general takāful, looking at the trend of surplus approved for distribution by individual takāful operators, three (3) major categories of takāful operators can be seen, i.e. takāful operators that have consistently distributed surplus, takāful operators that have distributed surplus only in recent years and takāful operators that have yet to generate enough surplus for distribution.
Chart 6 shows the average amount of surplus approved for distribution by takāful operators that have been operating for (i) more than ten (10) years; (ii) between five (5) and ten (10) years; and (iii) less than five (5) years. Similar to general takāful, the takāful operators that have been operating for more than ten (10) years have consistently been able to maintain their favourable surplus positions throughout the period for subsequent distribution, and the same goes for takāful operators that have been operating between five (5) to ten (10) years. In the case of takāful operators that have been operating for less than five (5) years, it is noted that, on average, they were only able to distribute surplus starting from 2013.

(b) Takāful Operators’ Surplus Position Computed Against Net Earned Contribution

Data on the SA for the year is computed against takāful operators’ NEC as a measure to reflect comparable level of surplus of takāful funds for the year.
\[ Y, \text{ as a measure of } \textit{takāful} \text{ fund’s level of surplus for the year} = \frac{\text{Total SA}}{\text{NEC}} \times 100 \]

In 2013, the surplus positions of all \textit{takāful} operators underwriting family \textit{takāful} business are noted to be below 30.0% of their individual net earned contribution position. Such results show that for every RM100.00 net earned contribution recorded by each \textit{takāful} operator for its family \textit{takāful} business, the surplus approved for distribution to participants and \textit{takāful} operators is less than RM30.00.

\textit{Chart 7: Surplus Approved for Distribution as % of Net Earned Contribution for 2013}

The results are further analysed in an attempt to establish the links between the \textit{takāful} operators’ number of years in operation with the level of surplus (SA as the percentage of NEC) within the respective family \textit{takāful} fund. \textit{Takāful} operators which underwrite family \textit{takāful} business are grouped in three (3) categories according to the number of years in operation; namely \textit{takāful} operators which have been in operation for more than ten (10) years, between five (5) and ten (10) years, and lastly for less than five (5) years. For 2013, individual \textit{takāful} operators’ length of operation is noted to have no linkage on the \textit{takāful} operators’ surplus arising during the year. This is apparent from the varying results of surplus position from the perspective of length of years in operation.
The summary of our findings based on the quantitative data is shown in Figure 5 below.

**Figure 5: Observation Summary on Takāful Operators’ Surplus Experience**

1. Undulate trend of surplus distributable to participants for period under review
2. 3 categories of takāful operators based on yearly trends in surplus distribution
   - Takāful operators that have consistently distributed surplus to participants
   - Takāful operators that distributed surplus only in recent years
   - Takāful operators that have yet to generate enough surplus for distribution
3. *+(ve)* correlation between surplus position and takāful operators’ length of operation
   - Takāful operators operating ≥ 10 years have more favourable surplus positions than takāful operators operating ≤ 10 years
4. Surplus as % of net earned contribution
   - Takāful operators operating ≥ 10 years have more stable surplus position (computed as % of net earned contribution) than takāful operators operating ≤ 10 years

**c. The Effectiveness of Surplus Distribution Practice in Takāful**

This study further attempts to establish how the practice of surplus distribution has impacted the takāful funds, as well as the effectiveness of such practice in reflecting participants’ stature as owners of the takāful fund and in aligning the interests of various stakeholders related to takāful operations. The findings are based on the authors’ observations on the practice of surplus management and distribution of takāful operators, sourced from the takāful operators’ websites, product brochures or marketing materials, financial statements and policy documents.

**(i) Effect of Surplus Distribution in Maintaining a Strong and Sustainable Takāful Fund**

In general, the relatively young takāful operators (i.e. in terms of number of years of operation) tend to retain a significant portion of surplus arising each year. This is reasonable given the need to
build up a sizeable portfolio for long-term sustainability of the funds, a position which other takāfīl operators that have been in operation longer would have been able to achieve earlier.

In addition, the effect of surplus distribution on the strength of the takāfīl fund is also to some extent dependent on the segregation of funds as applied by the takāfīl operators. Where funds segregation is minimal (e.g. contributions of various products are pooled together in one (1) or two (2) funds), the cross-subsidisation amongst different product lines is more effective, i.e., ‘surplus’ from one product line can be used to cover the poorer underwriting experience in other product lines. In contrast, where takāfīl funds are segregated more granularly, the chance of surplus emerging in any one fund is limited to the performance of the products/risks covered within that one fund only. Thus, surplus sharing may be constrained for sub-funds with poor underwriting performance.

Out of the eleven (11) takāfīl operators that carry out family takāfīl business, eight (8) of the operators apply granular segregation within their family takāfīl funds. This is mainly due to legacy issues for certain individual operators (such as the decision to change the operational business model—resulting in at least two (2) funds to cater for each of the models) and the differentiated approaches in managing different takāfīl products, for example products with different fees or remuneration structures. The general takāfīl fund, on the other hand, is mainly confined to one fund without further segregation. Thus, the constraints on the amount of surplus arising from the size of takāfīl funds or sub-funds are more prevalent in the family takāfīl business.

(ii) Surplus Sharing as a Tool in Aligning the Interests of Participants and Takāfīl Operators

Allowing surplus distribution to both participants and takāfīl operators does have its merit as it serves as a tool to align the interest of these parties. As manager of the takāfīl operation, the takāfīl operator does not bear the underwriting risks of the takāfīl fund. Any loss arising in the takāfīl fund is borne only by the pool of participants (in lieu of any qarḍ or interest-free loan by the
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In terms of remuneration, the *takāful* operator is mainly remunerated through the *wakālah* fees, which are paid upfront by the participants and irrespective of the underwriting experience of the *takāful* fund. Thus, there may not be a real motivation for the *takāful* operator to ensure good management of the *takāful* operation. Allowing *takāful* operators to share a portion of the surplus can serve as an incentive to motivate the *takāful* operators to manage the *takāful* fund more effectively and efficiently. As such, at the end of the financial period, the surplus emerging will benefit not only the participants but the *takāful* operators as well.

The notion of surplus itself (i.e. prior the distribution to the participants and the takaful operator) also provides a worthy business strategy for the *takāful* operators, as it not only provides potential returns to participants, it also reduces the need for the *takāful* operators to be capital intensive. Where a *takāful* fund has a substantial amount of surplus retained, the likelihood of the *takāful* fund withstanding any adverse underwriting experience (e.g. bad claims experience) is higher, without requiring any form of financial assistance such as an interest-free loan from the *takāful* operators. It also provides room for the *takāful* operators to increase the *takāful* fund’s underwriting capacity, allowing it to underwrite more risks which may include larger and more risks (subject to the underwriting policy of each *takāful* operators), alongside motivating the *takāful* operators to beef up their technical expertise. However, such benefit can only be reaped once a substantial amount of surplus has emerged (and retained) in the *takāful* fund. Thus, for ‘young’ *takāful* operators with little or no surplus, this may not be entirely applicable. There is a need for these *takāful* operators to balance the amount of surplus to be retained for the abovementioned purposes with the amount to be distributed to the participants in order to maintain the attractiveness of the *takāful* arrangement.

To be able to implement all of the above effectively, *takāful* operators need to undertake active and continuous efforts to educate participants and the public at large on the concept of

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1 All *takāful* operators in Malaysia currently apply the *wakālah* operational model.
surplus and the benefits of surplus sharing. This will bring us to the next point, i.e., the importance of disclosure on surplus sharing to the participants.

(iii) Importance of Surplus-Sharing Practice Disclosure in Supporting Participants’ Stature as Owners of the Takāful Fund

The information on surplus that is conveyed by takāful operators to the public is usually general and broad. This might be driven by the takāful operators’ dilemma in deciding the extent of disclosure necessary. Based on our assessment, the common channels utilised by takāful operators for disclosure on surplus-related information are the takāful operators’ websites, financial statements and product brochures. In most cases, only basic information about surplus is disclosed; namely, treatment of the surplus (i.e., whether it is shared and distributed or not), the ratio of surplus that will be distributed, when it will be distributed and general calculation of it. Only a few takāful operators provided a definition of surplus, which is considered necessary core information to be communicated to the public to facilitate an appropriate understanding of surplus and the principles behind its distribution.

Another likely source of information on surplus is the takāful policy document, typically worded broadly to facilitate the understanding of participants. The agreement by participants on surplus distribution is usually captured in the ‘aqd (contract), which is drafted in general terms, with no specification on how the surplus is determined and allocated (e.g. solely based on the experience of the participant’s own portfolio or in consideration of other participants’ portfolios). The method of allocation is often not disclosed to participants, with the exception of a few takāful operators who did disclose their method of allocation on their websites. The extent of public disclosure made on the actual surplus experience is also usually limited to what is disclosed in the financial statements of the takāful operators. The drawback of these financial statements is that the figures reported depict the overall surplus results of family and general takāful funds. Thus, for the family takāful fund, which is segregated further
into multiple sub-funds, participants are not able to ascertain the actual surplus experience of the particular sub-fund relevant to them.

IV. CONCLUSION AND RECOMMENDATIONS

The findings on the surplus management and distribution practice of the takāful operators in Malaysia indicate the criticality of sound and robust surplus management. Effective surplus management will not only support the long-term well-being of the takāful fund, which is in the interest of the participants (i.e. the takāful operator’s clients), it will also help promote the competitiveness of the takāful operator itself. The uniqueness of the surplus-sharing feature can also be one of the tools to attract consumers towards subscribing to takāful.

More importantly, the application of internal guides on surplus sharing set by takāful operators must be reflective of the operators’ fiduciary duties to the participants, to whom the ownership of the takāful fund (and hence surplus) belongs.

Several areas of the existing practice on surplus management can be further improved, particularly from the aspect of providing adequate disclosure to the participants on entitlement to the surplus, method of determination and allocation of surplus. Greater transparency on surplus distribution will facilitate the participants’ better understanding of the unique features provided in takāful and possibly create more appreciation of the true nature of takāful by the public at large. Besides reducing the information asymmetry in regard to distribution of surplus among the public, such transparency in disclosure will also be more reflective of the fundamental principles of Islamic finance regarding fairness and integrity in all undertakings. For future work relevant to the surplus as a unique feature in takāful, a study on the effectiveness of the surplus in enticing consumers’ interest in participating in the takāful contract could be explored. This could be approached from the perspective of both retail and corporate consumers’ perceptions and awareness of the concept of surplus.
References


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