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Surplus treatment in Takaful companies

Introduction

Takaful is a risk sharing management tool which emerged in response to the risk transfer tool in conventional insurance. It is based on mutual help and cooperation. The concept appeared long ago and dates from the pre-Islamic era through Aqila, Dhaman Khatar Tariq, Diya and other practices having been approved by the advent of Islam.

Conventional insurance is based on the transfer management tool which enables the insured to pay a premium on the basis of a sale contract: the insured pays a premium as a price in exchange for the insurance coverage and protection offered by the insurer. Doing so, the insured transfers the risk to the insurer for a certain amount of money, thus the uncertainty is transferred to the insurer. Such a mechanism is not allowed by Sharia since transferring risk and uncertainty is likely to bring about a main prohibited element that is Gharar.

According to Takaful mechanism, risk is not transferred but shared among participants who are owners of the same risk pool called participants' fund made out of the participants' contributions. Such a fund is then used to indemnify any participant undergoing a loss.

It is evident that insurance companies, whether they are sharia compliant such is the case for Takaful companies, or non-sharia compliant such are conventional insurance companies, either for profit or not—for-profit companies, have to cover the expenses incurred because of claims.

Surplus then is the amount of money remaining from the participants' fund when total contributions paid by participants, less total value of claims paid, less operator fees charged, less any reserves for outstanding claims. The balance can either be a surplus if it is positive or a shortfall if it is negative.

In case of deficit or shortfall, the operator undertakes to cover the required amount under an interest-free loan to be recovered from the participants' future contributions.

Surplus is not profit. Profit is incurred if investment operations have been conducted and total revenue exceeds total cost. Such a profit is shared on a predetermined basis according to Mudarabah model, or for certain predetermined percentage or fees according to Wakalah model.

Any surplus arising from the risk fund is to be distributed or treated according to AAOIFI Sharia standard No 21 which states four ways for surplus distributions.

According to the standard, Takaful surplus is considered as part of the assets of the company.

"Distribution of the surplus or part of it among the policyholders should be in one of the following forms, provided that the selected form is explicitly mentioned in the regulations:

(A) Distribution of the surplus among the policyholders in proportion to their respective contributions, and regardless of whether the policyholder has received indemnity during the financial period or not.

(B) Distribution of the surplus among the policyholders who have not received indemnity during the financial period.

(C) Distribution of the surplus among policyholders after deducting the amounts of indemnity they receive during the same financial period.

(D) Distribution through any other method approved by the Shariah Advisory Board"

The standard determines four ways of surplus distribution. According to method A, surplus is distributed among policyholders according to the amount of their contribution regardless of whether the participant had been indemnified for a loss or not during the concerned financial period of coverage.

The second way is to distribute the surplus among those who have not been indemnified for any loss and those having been indemnified receive nothing.

The third method is to distribute the surplus among all policyholders after deducting any indemnifications and claims during that period.

According the fourth way, the standard left it open to the Sharia Board to decide where the surplus is to be disbursed.

In terms of surplus sharing within the Takaful Company, the surplus proportion to be given back to policyholders is determined by the Takaful contract on an annual basis. However, the amount itself depends on the financial results of each year.

Some scholars view that running a Tabarru' pool which is a non-profit mechanism with a commercial contract is controversial. Some view that distributing a surplus is against the very basic objective of creating a risk fund. Participants contribute to the fund with the pure intention to help one another when a misfortune occurs and they are not expecting any return.

In Wakalah contract Takaful operators found sharia justification to get a portion of surplus distribution as performance fee for excellent management of the risk pool. This makes surplus distribution identical in both Wakalah and Mudarabah.

Some marketers on the other hand began marketing for their Takaful products, as a differentiation tool from conventional insurance, on the basis of surplus distribution, which mistakenly leads the public to think that there is always a surplus distribution and no shortfall may occur.

This volatility forces Takaful operators to build reserves during good times to anticipate bad times in the future. Takaful operators do not declare all surpluses, part or even all of it must stay in the pool because of the necessity of creating reserves for bad times when claims exceed the amount contained in the risk pool.

When the reserve pool is considered as abundant, a surplus can be declared. In many cases, this abundance of reserve may never come true due to the volatility of results from time to time.

Conclusion

To conclude, surplus as an outcome of a Tabarru fund is not an integral part of Takaful scheme. AAOIFI standard, in the fourth paragraph stipulated the right to Sharia Supervisory Board to distribute the surplus according to the way they deem the most convenient and Sharia compliant.

Although nascent and still immature, Takaful industry is doing well.