SURPLUS-SHARING PRACTICES OF *TAKĀFUL* OPERATORS IN MALAYSIA

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Abstract

In takāful (Islamic insurance), surplus in the takāful 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 takāful fund after taking into account total claims paid, amount payable for retakāful contributions, reserves allocated and investment profits accrued to the fund. Given the rightful roles of takāful operators as 'managers' of the takāful 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 takāful 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 takāful operators. The paper also sets out to establish the effectiveness of the existing practice in promoting a strong and sustainable takāful fund, upholding participants' stature as owners of the takāful fund and enticing consumers to participate in takāful, 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 takāful. The study affirms that, in actual practice, the surplus generated from the takāful fund is distributed between participants and takāful operators, with variation seen from the perspectives of frequency of distribution, method of distribution and specific Sharīʿah contracts used to underlie the distribution. Several improvements on the disclosures of information on surplus are also suggested in the paper.

Keywords: *Takāful*, 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 *tabarruʿ* (donation) and *taʿāwun* (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 *tabarruʿ* 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-ā-vis its application in conventional insurance as well as the Sharīʿah 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 Ikhlas 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. Fiqhī Views on Surplus Distribution in Takāful

There have been long debates on the rightful practice of surplus distribution from the Sharīʿah 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 *tabarruʿ*, 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).

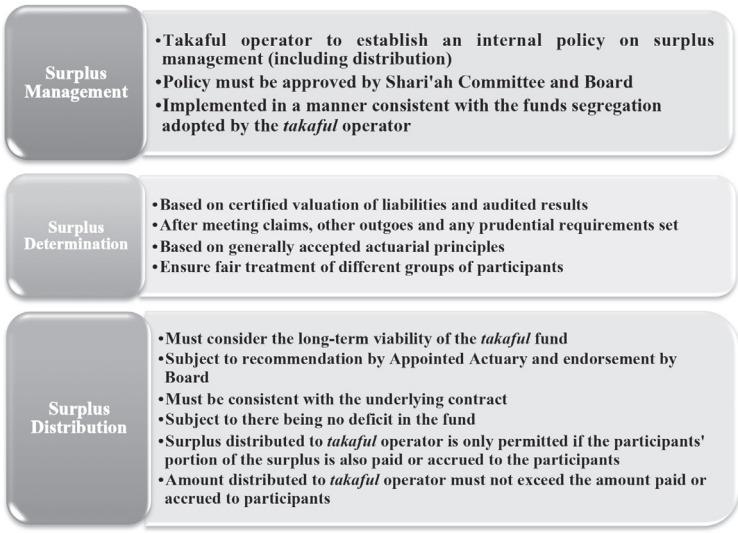
Despite these differing views, the majority of *takāful* markets around the world have allowed surplus to be distributed and shared between participants and *takāful* operators, e.g., Bahrain, Qatar, Pakistan, and Jordan. In Malaysia, the Shariah Advisory Council of Bank Negara Malaysia (the SAC), in 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 *muḍārabah* 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).

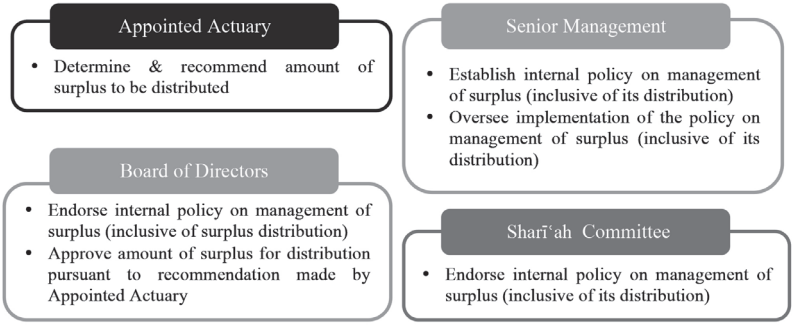
In 2010, Bank Negara Malaysia issued the Guidelines on Takaful Operational Framework (TOF), which has specific sections governing the management of surplus, determination of surplus and its distribution. According to the TOF, which was made effective on 1 January 2012, *takāful* operators are required to establish their own internal policy on the management of surplus, approved by the Sharīʿah Committee and the Board of Directors. The policy must be in compliance with Sharīʿah 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.

Figure 1: Takāful Operational Framework's Requirements on Surplus Management, Determination and Distribution



Source: Bank Negara Malaysia

Figure 2: The Parties involved in Surplus Management, Determination and Distribution



Source: Bank Negara Malaysia

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

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

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 Sharī'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.

Source(s): Qatar Financial Centre Regulatory Authority's Insurance Business Rules 2006; Central Bank of Bahrain's RuleBook; Takāful Rules 2012 of the Insurance, Securities and Exchange Commission of Pakistan.

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

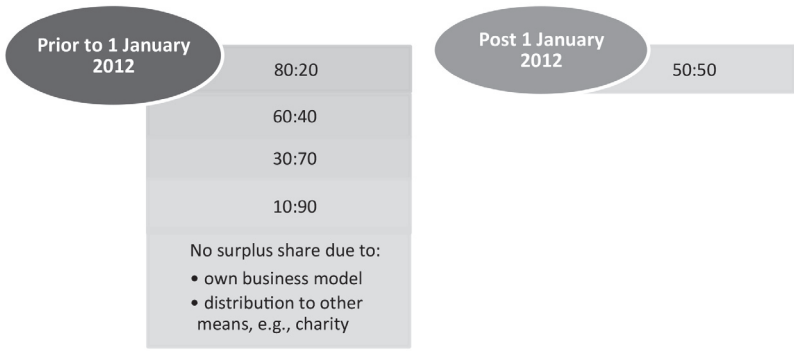
a. Background Information on the Malaysian Takāful Market

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 *takāful* operator varied across *takāful* operators and product lines. The ratios (participants:*takāful* operator) were as high as 90:10 and as low as 20:80. With the implementation of the TOF, *takāful* operators' practices on surplus are changing. Currently all *takāful* 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 *takāful* operators who previously enjoyed a much lower share of surplus. Figure 3 shows the ratios of the distribution adopted by the *takāful* operators prior to 1 January 2012 and after that date.

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

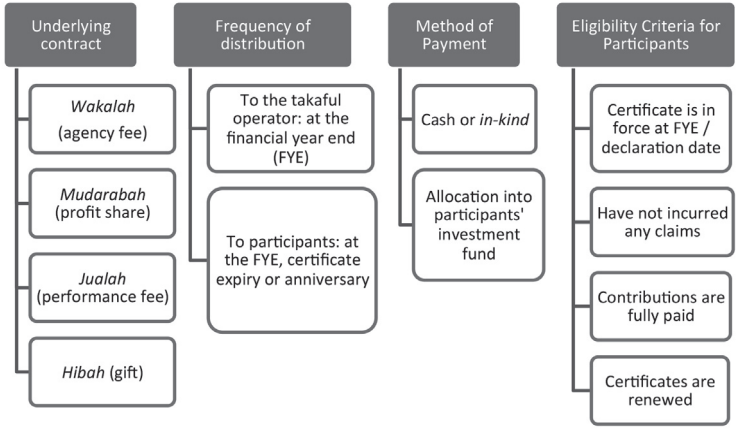


Source: Bank Negara Malaysia

Guided by the principles and parameters set out in the TOF, *takāful* operators further set their internal policies on surplus management, which involved the common areas identified in Figure 4. Notably, *takāful* operators exhibited transparency in their approaches towards surplus management to the public, though at varying levels of detail. Some *takāful* 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 *takāful* 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

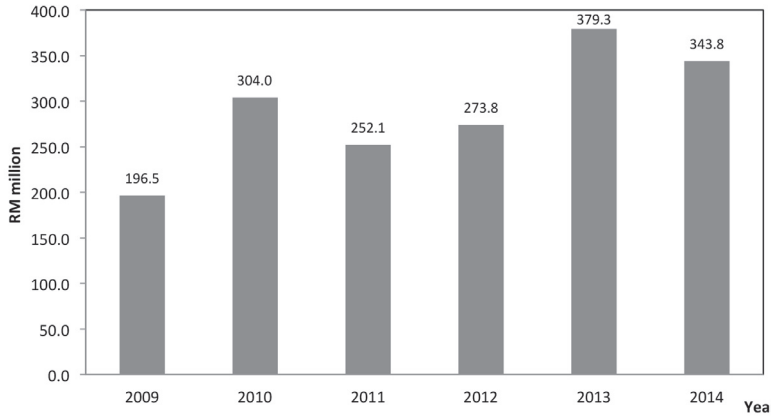
The amount of surplus arising in any particular year would reflect the underwriting and investment experience of the *takāful* fund, i.e., the surplus can result from better-than-expected experience in claims, lapse in the coverage, any changes in valuation basis as well as investment. All of these permutations 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

Chart 1: Total Industry's 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: Average Surplus Approved for Distribution to Participants and Takāful Operators for 2009-2014 Based on Years of Operation

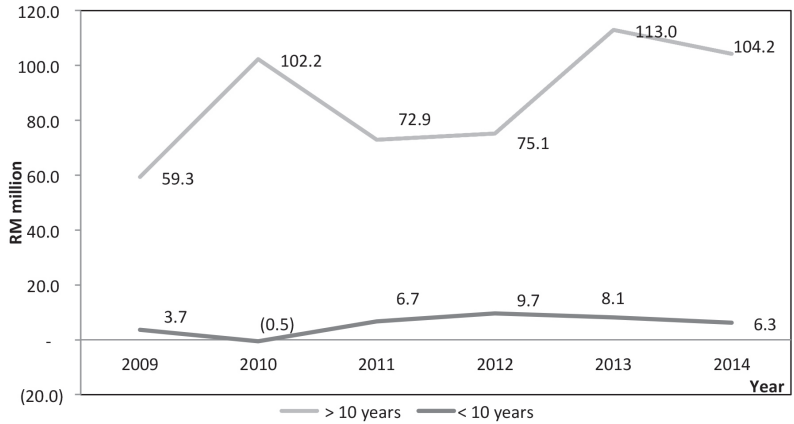


Chart 2 depicts the average amount of surplus approved for distribution by *takāful* operators that have been operating for (i) more than ten (10) years and (ii) less than ten (10) years. *Takāful* operators that have been operating for more than ten (10) years are noted to have been able to maintain 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 2: Correlation Test Result for Linkage between Takāful Operator's Length of Operation and Surplus Position for 2009–2014

	2009	**2010**	**2011**	**2012**	**2013**	**2014**
CORRELATION	0.96	0.98	0.97	0.97	0.7	0.76

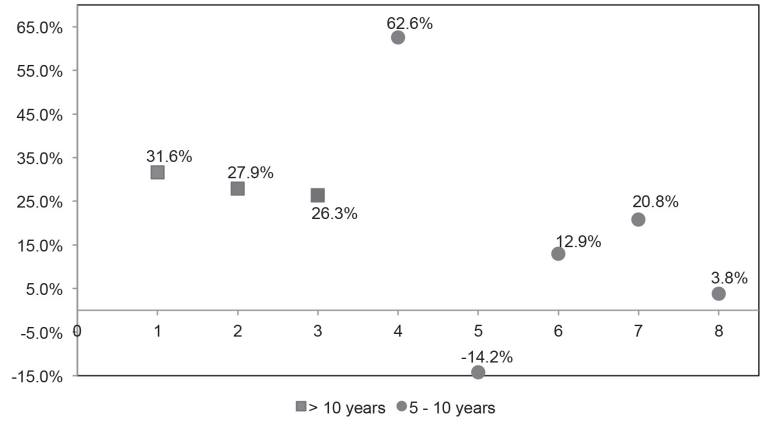
(b) *Takāful* Operators' Surplus Position Computed Against Net Earned Contribution

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 *Ys*) 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

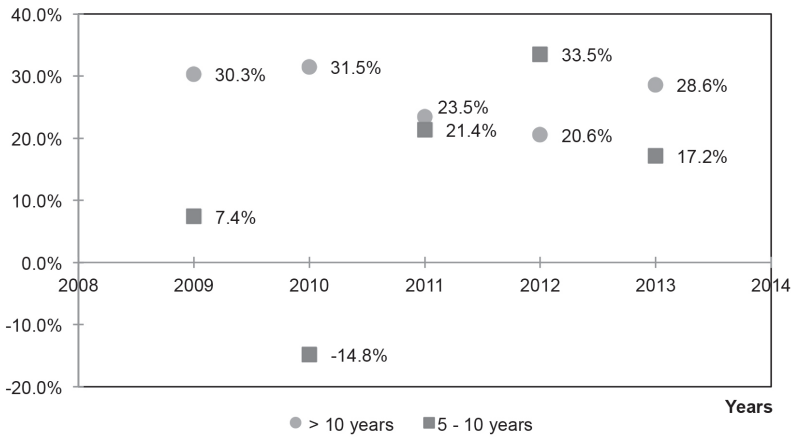


The results are further analysed in an attempt to establish the links between the *takāful* operators' *number of years in operation* with the *level of surplus approved for distribution for the year* (SA as the % of NEC) within the *takāful* operators' general *takāful* fund.

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.

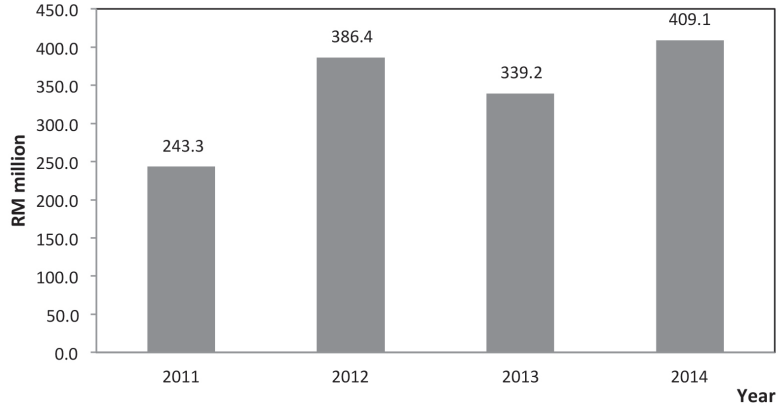
Table 3: Correlation Test Result for Linkage between Takāful Operator's Length of Operation to Surplus Position as % of Net Earned Contribution for 2009–2013

	2009	2011	2011	2012	2013
CORRELATION	0.7	0.59	0.34	0.02	0.29

ii. Family Takāful Fund

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

Chart 5: Total Industry's 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: Average Surplus Approved for Distribution to Participants and Takāful Operators for 2011-2014 Based on Years of Operation

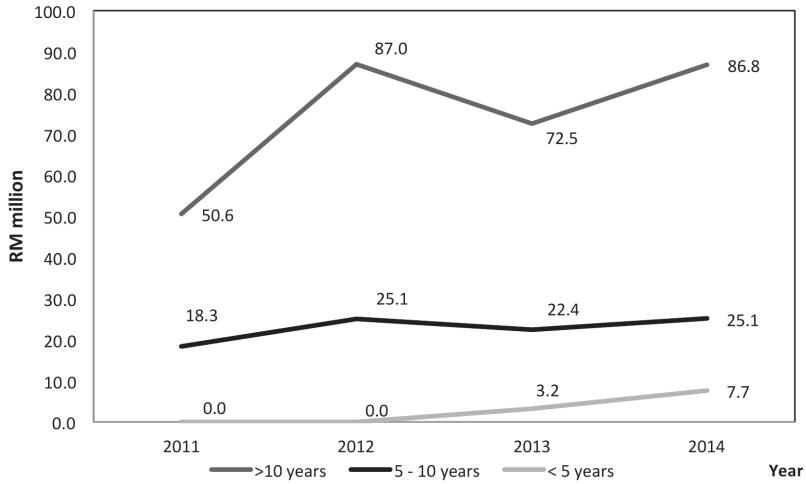


Chart 6 shows the average amount of surplus approved for distribution by *takāful* operators that have been operating for (i) more than ten (10) years; (ii) between five (5) and ten (10) years; and (iii) less than five (5) years. Similar to general *takāful*, the *takāful* operators that have been operating 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.

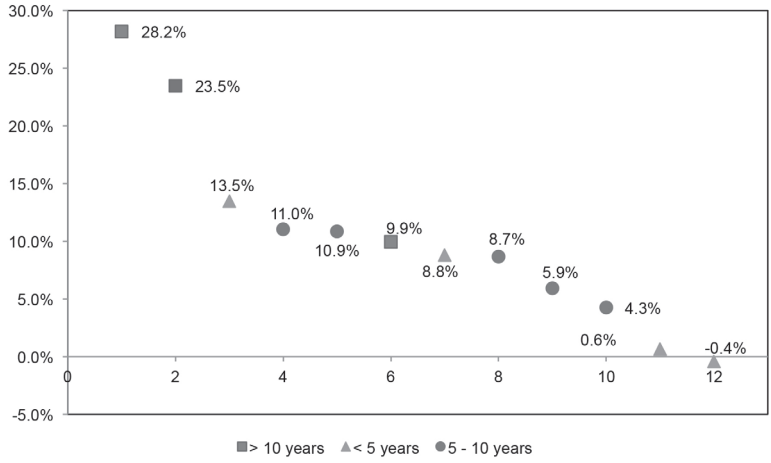
(b) *Takāful* Operators' Surplus Position Computed Against Net Earned Contribution

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.

$$Y, \text{ as a measure of } takāful \text{ fund's level of surplus for the year} = \frac{\text{Total SA}}{\text{NEC}} \times 100$$

In 2013, the surplus positions of all *takāful* operators underwriting family *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 *takāful* operator for its family *takāful* business, the surplus approved for distribution to participants and *takāful* operators is less than RM30.00.

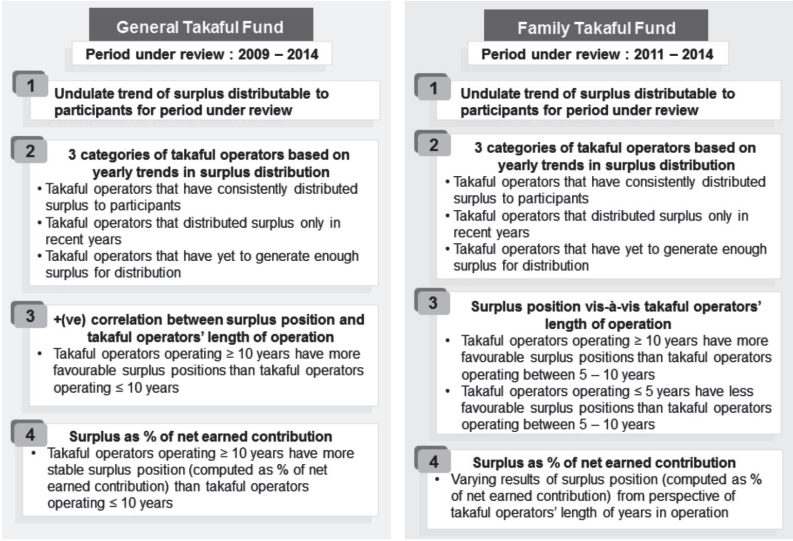
Chart 7: Surplus Approved for Distribution as % of Net Earned Contribution for 2013



The results are further analysed in an attempt to establish the links between the *takāful* operators' number of years in operation with the level of surplus (SA as the percentage of NEC) within the respective family *takāful* fund. *Takāful* operators which underwrite family *takāful* business are grouped in three (3) categories according to the number of years in operation; namely *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 *takāful* operators' length of operation is noted to have no linkage on the *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



Source: Authors' Own

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 *takāful* 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 *takāful* fund is also to some extent dependent on the segregation of funds as applied by the *takāful* 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 *takāful* 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) *takāful* operators that carry out family *takāful* business, eight (8) of the operators apply granular segregation within their family *takāful* 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 *takāful* products, for example products with different fees or remuneration structures. The general *takāful* 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 *takāful* funds or sub-funds are more prevalent in the family *takāful* business.

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

Allowing surplus distribution to both participants and *takāful* operators does have its merit as it serves as a tool to align the interest of these parties. As manager of the *takāful* operation, the *takāful* operator does not bear the underwriting risks of the *takāful* fund. Any loss arising in the *takāful* fund is borne only by the pool of participants (in lieu of any *qarḍ* or interest-free loan by the

takāful operators). In terms of remuneration, the *takāful* operator is mainly remunerated through the *wakālah*[1] 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

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 *ʿaqd* (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.

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Research Notes