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Surplus Distribution Issues in Takaful and Retakaful

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ISLAMIC INSURANCE / TAKAFUL

Some Definitions

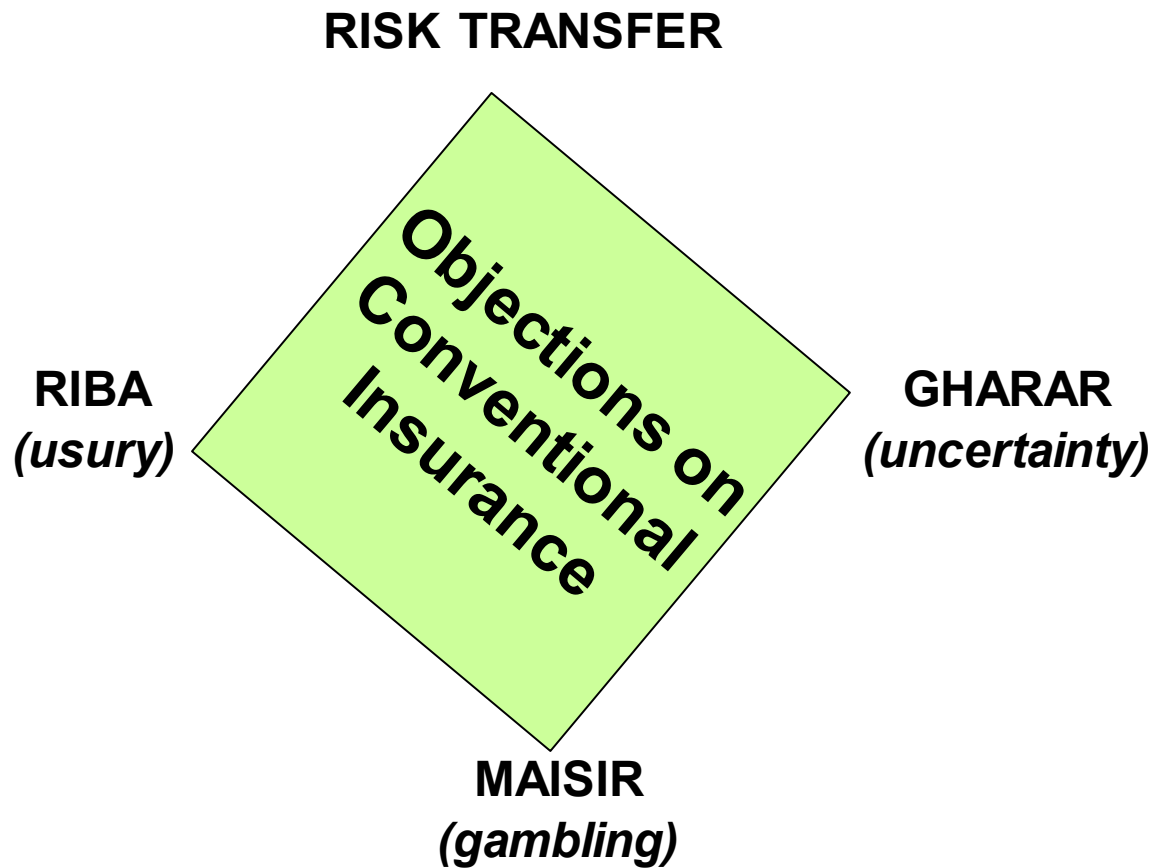
- Islamic Insurance is a system through which the participants donate part or all of their contributions which are used to pay claims for loss suffered by some of the participants. The company's role is focused on managing the insurance operations and investing the insurance contributions.
- A scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose.

Takaful & Conventional Insurance : Head-to-Head

CONVENTIONAL INSURANCE	TAKAFUL
Risk transfer mechanism from the risk owners to other party (the insurance company)	Risk Sharing mechanism amongst the risks owner that is administered by the company
The risk owner is the Insured	The risk owner is the participant of the group/pool that share risk among themselves (guarantee each other)
The company is the Insurer that bear the risk	The company is the operator or administrator of the risk sharing system
The whole premium belong to The company	The Contribution (premium) belong to participants collectively or in waqf model, belong to nobody
All Profit or Surplus goes to the company	Profit or surplus belong to the participants or the waqf fund
Deficit will be borne by the company	Deficit of the fund is responsibility of the participants, but the company is required to deal with it by giving Qard Hasan (benevolent loan)

CONVENTIONAL INSURANCE

Islamic Scholars' Objections



Surplus Distribution Under Mudaraba Model

- Mudaraba is the first envisaged operational model in the earlier day of takaful
- Mudaraba is defined as a contract between two parties, where one party give money to another for investing it in a commercial enterprise.
- Since mudaraba is a commercial contract, provision or condition on profit is a main pillar of mudaraba.
- When mudaraba is deployed in takaful contract, profit sharing has to be embedded; otherwise the contract will be invalid.
- However, non-profit nature of takaful concept has brought hesitation of using word 'profit'. Hence, the word 'surplus' is used. And Surplus Distribution is introduced to replace Profit Sharing.

Surplus Distribution Under Wakala Model

- Wakala is a contract when a person appoints a representative to undertake transactions on his/her behalf.
- Under wakala model, takaful operator acts as agent of participants to conduct certain tasks for certain fee.
- In its original form, wakala contract does not have any component of profit sharing or surplus distribution.
- Interestingly however, when most takaful operators migrated from mudaraba to wakala, Surplus Distribution remains as part of many takaful products.
- The argument behind Surplus Distribution under Wakala: fund in the pool is collectively owned participants, so it is their right to decide how to treat any surplus raises.
- Justification for Takaful Operators to receive a portion of surplus distribution: performance fee for excellent management of risk portfolio.

Takaful = Conventional Insurance + Surplus Distribution?

- Surplus distribution has become a major selling point of takaful, irrespective operational model used.
- Takaful Marketer to participant: takaful is better than conventional insurance because at the end of the period, they will get their money back.
- Severe misunderstanding that takaful is basically insurance with surplus distribution.
- Surplus distribution overshadows the holy concept of risk sharing/solidarity

Viability of Surplus Distribution in Takaful

Surplus Distribution is not technically sustainable measure due to:

- business of insurance or takaful is not as simple as running a local store where profit = turnover - purchasing cost - other expenses.
- In insurance or takaful, the 'commodity' managed in the pool is **risk**, the uncertainty itself.
- Inherent volatility requires strong reserve to be built within the pool
- More rigorous regulation on solvency margin
- Competition pushes original contribution downward

Surplus Distribution may contradict with Takaful basic concept

- Takaful is alternative risk management tools offered by Islamic fiqh to replace unacceptable conventional insurance.
- Risk is not transferred to the insurance company, but shared among participants.
- Takaful bases on *tabarru'* (doing good deeds to one other) or *takaful* (guaranteeing one another)
- Participants pool their risk and fund to help each other without expecting any profit in return.
- Pool of fund is non-profit entity
- Surplus Distribution is basically profit sharing being applied on non-profit scheme

Viability of Surplus Distribution in Retakaful

Surplus Distribution is even less technically sustainable for retakaful, due to:

- Wider geographical scope of retakaful business (SEA, Sub-Continent, MENA..).
- Wider business scope of retakaful (Property(EQ), Motor-TPBI, GA, PI, Energy, Aviation, Life...)
- So much higher level of surplus volatility, which requires both an intelligent pooling system as well as a strong retakaful management.
- This all in addition to what has been said in the case of takaful.

Conclusion

- The core of takaful is risk sharing and sincere acts of helping among fellow human beings without profit orientation.
- Surplus Distribution is not an integral part of takaful scheme.
- Absence of Surplus Distribution does not make takaful invalid as far as shariah compliance is concerned.
- Surplus Distribution may be against the basic value of takaful.
- Surplus Distribution is not a technically sustainable measure for Takaful operator and even less for a retakaful operator (Volatility).
- Severe misunderstanding that Takaful = Insurance + Surplus Distribution.
- Takaful industry needs to fix this misconception and re-educate market and public.

- Misconceptions happen because in some cases, people think as follows:
- Because $5 = 3 + 2$
- And $5 = 4 + 1$
- we tend to think that if both operations lead to the same figure of 5 then
- $3 = 4$ and $2 = 1$
- So simple are misconceptions!

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