

# Solvency of *Takāful* Fund: A Case of Subordinated *Qarḍ*

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*There are two elements important in formulating the solvency requirements of a takāful undertaking namely the takāful fund and qarḍ facility. It has been seen in some regulatory frameworks that the regulator puts a requirement on the takāful operators to show that they are providing some financial support towards the solvency of the takāful funds. This paper attempts to explain the measures involved in the takāful operator using their shareholders' funds to provide financial backing to support the solvency of takāful funds through the practices of qarḍ facility, injection of assets into the takāful funds and assignment or allocation of assets in the shareholding to the takāful funds. The paper will focus on the nature of qarḍ and its basis in the primary sources of Sharia'h. Is it acceptable legally to subordinate qarḍ in the case of deficit, deficiency or drawn down of takāful fund? Finally, the paper will analyze the legal ruling related to qarḍ and how it is different to conventional insurance practices.*

## 1. Introduction

Solvency of *takāful* fund and legality of the condition of *qarḍ* facility are significant issues for their impact on the capital requirements for *takāful* undertakings. Sharī'ah rulings and *takāful* regulations differ across different countries. Since the legal and regulatory landscape of the *takāful* industry is still in its infancy, development and harmonization of the prudential regulation and supervision of *takāful* companies at the international level remains a challenge. *Takāful* funds tends to be divided into two schemes namely: General *takāful* and Family *takāful*. This paper briefly examines the nature of *tabarru'* in *takāful* and the resulting legal effects on the solvency of both kinds of *takāful* funds. The paper only focuses on that part of *takāful* funds which is allocated for coverage of risks and claims (risk funds), not the savings / investment portions of the funds (in family *takāful*) which clearly belong to the individual participants.

## 2. General *Takāful*

The general *takāful* undertaking is a short-term contract where participants pay contributions and operators undertake to manage risk. The contributions paid by the

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participants are credited into the general *takāful* fund, which is then invested and the profits generated are paid back to the fund.

General *takāful* schemes are basically contracts of joint guarantee on a short-term basis (normally one year), providing mutual compensation in the event of a specified type of loss. The schemes are designed to meet the needs for protection of individuals and corporate bodies in relation to material loss or damage resulting from a catastrophe or disaster inflicted upon real estates, assets or belongings of participants. The *takāful* contribution paid is pooled into the *takāful* fund under the principle of *tabarru'* to match the risk elements of the business that are inherent in its underwriting activities.<sup>2</sup>

Although investment activities in the general *takāful* pool or fund are secondary to the underwriting activities, they may be important for the solvency of the fund, especially in the case of longer-tailed risks.<sup>3</sup>

The contributors' payments are divided into management cost, risk management, surplus and Special Security Fund (SSF). Management cost is divided into commission, management cost and establishment cost, which covers bills and other miscellaneous expenses. The commission is meant for staff salaries and is determined by the *takāful* operator, which is deducted from the management cost. Commission can also be paid by the participant through mutual consent and agreement.

A percentage of the participants' contribution also goes to the Participants' Risk Fund (PRF), which backs up the *takāful* fund and handles the risk of insolvency. A certain percentage of a predicted amount is contributed to the Participants' Risk Fund (PRF) as a reserve for bankruptcy. For instance, a company may estimate the probability of bankruptcy for the next 10 years and calculates that it will reserve RM10 million (US\$2.69 million) for back up. The participants then contribute 2% of *takāful* fund, each *takāful* fund to fulfill the reserve requirement of RM10 million (US\$2.69 million), which will be held by the Central Bank. This money cannot be touched by the Central Bank and will not earn or lose any interest. If the *takāful* fund becomes insolvent before the predicted 10 years, say in five years, the Central Bank will return RM5 million (US\$1.35 million) from the reserve to the company. If the company does not become insolvent after 10 years, the reserve remains untouchable. The purpose of this is to protect the benefits and interest of the participants. The regulators will need to ensure that *takāful* operators are prudent in maintaining sufficient reserves to protect themselves and participants against untoward events in their operations. The more risky the *takāful* operator, the more capital it needs to put aside to provide a cushion against things going wrong.<sup>4</sup>

A proposal has been mooted to use the *qard* facility in the SSF mechanism. From the RM10 million (US\$2.69 million) the company reserved in the Central Bank, it will get back RM1 million (US\$269,025) for every year it earns profit. Thus, if the company

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<sup>2</sup> The IFSB-8 (December 2009) Guiding Principles on Governance of *Takāful* (Islamic Insurance) undertakings.

<sup>3</sup> See: IFSB-8 (December 2009) Guiding principles on Governance of *takāful* (Islamic insurance) undertakings, p 6.

<sup>4</sup> See Tobias Frenz & Younes Soualhi (2010) pp 204-209.

earns RM1.5 million (US\$403,509) profit in the first year, the Central Bank will return RM1 million (US\$269,025) to the company. However, if this occurs every year, and the money that is returned is then used or invested, and the company becomes insolvent in the ninth year, there will be insufficient reserved funds left to cover the loss. To avoid these consequences, the returned reserved money could be credited to another company account where it could not be touched, specifically for back-up purposes. The Central Bank would no longer hold the reserve.

### 3. Family *Takāful*

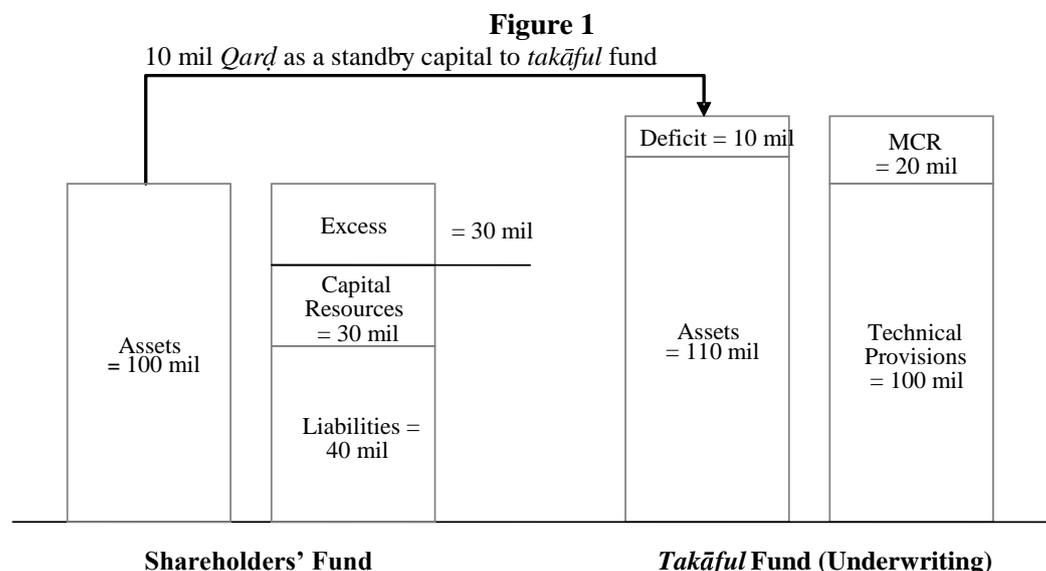
Family *takāful*, does not mean insuring one's life, but is a financial protection for the heirs or beneficiaries of the deceased (or insured) against future unexpected financial risk. Family *takāful* deals with the provision of financial relief to the participants and/or their family in the event of misfortunes that relate to the death or disability of the participants. This category of *takāful* normally requires the *takāful* operator to engage in a longer-term relationship over a defined number of years with the *takāful* participants, throughout which the participant is required to make regular instalment payments in consideration for his or her participation in the *takāful* scheme.<sup>5</sup>

In family *takāful*, the paid *takāful* contribution of a participant will usually be divided into two accounts which feed two different funds. The first is the participant's investment fund (PIF), and the aggregate PIFs constitute an investment fund for the purpose of capital formation. The second is the participants' risk fund (PRF) which is a risk or *takāful* fund – i.e. an element of the business that is inherent in the underwriting activities, and the contributions to which are made on the basis of *tabarru'* commitment.

However, one of the key specificities of a *takāful* undertaking is a distinct separation between the *takāful* fund and shareholders' funds as illustrated in the table below:

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<sup>5</sup> For more details see: IFSB-8, pp 5-6.



The segregation of the amounts credited to the PIF and the PRF, respectively, is commonly made based on certain percentages of the *takāful* contributions paid, and this is normally part of the family *takāful* product pricing and design. The *takāful* operator will indicate in the family *takāful* contract the distinction between the two accounts and their relative proportions within the overall contribution, which cannot be unilaterally altered throughout the duration of the *takāful* contract. Family *takāful* consists of two types of funds: participant's risk fund (PRF) and participant's investment fund account (PIF).

The segregation of funds is to facilitate better management of investments activities and risk management. The separation of risk and savings/investment components is deemed necessary to recognize the different ownership, purpose and risks associated with the contributions. Profit is distributed to participants according to their contribution or investment in the family *takāful* fund, based on the terms and conditions applied by the company. The contribution paid by the participants in family *takāful* is allocated for management costs, which comprises commission, management costs and the SSF account. The majority of the contribution paid for family *takāful* is invested in PRF and PIF.

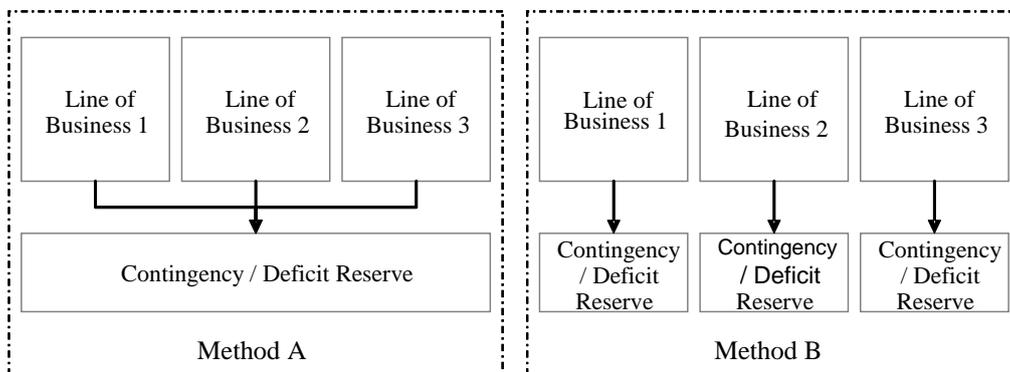
#### 4. Methods of Reserving

The management of reserves is the key element for having adequate capital resources in *takāful* funds. However, the method of reserving may vary and to a certain extent could determine the transferability of these capital resources between the lines of business. The determinants of fund transferability depend on the contractual term or even legal framework that governs the operational aspects of the overall *takāful* undertaking. Some *takāful* products may have so-called ring-fenced structures, where part of the business is segregated from the rest of other operations in a ring-fenced fund. This ring-fenced fund should be understood as a contractual or legal arrangement whereby part of the assets or

eligible surplus of the fund is strictly segregated from the rest of other lines of business and can only be used to meet the *takāful* and *retakāful* obligations with respect to which the ring-fenced fund has been established. As a consequence, the capital resources in the undertaking held within the ring-fenced fund can only absorb the losses stemming from the risks associated with the ring-fenced portfolio and will not be available to meet the other fund obligations and cannot be transferred from the rest of the activity, on a going concern basis

To facilitate the analysis of fund transferability in the reserving method, a simple example is illustrated in Figure 2. In this illustration, there are two methods, namely, Method A and Method B. All reserves from the various lines of business in Method A are pooled into a common reserve fund. These reserves are construed as being available in the sense that the reserves could be withdrawn and transferred to the lines of business in the event of deficiency in one of the business line. However, Method B shows that reserves allocated specifically to one line of business. Potentially Method A could be abused to boost the distribution of underwriting surpluses for a particular line of business. If this is the case, the practice should be prohibited. The objective of having a common pool of reserves is to serve the purpose of providing a solvency buffer for the *takāful* funds.<sup>6</sup>

**Figure- 2 Contingency / Deficit Reserves**



### 5. Shari‘ah Regulatory Measures for Solvency of *Takāful* Funds

There are some regulatory measures for solvency of *takāful* fund which Dr. Engku has explained that it has been seen in some regulatory frameworks that the regulator puts a duty on the *takāful* operators to show that they are providing some financial support towards the solvency of the *takāful* funds.<sup>7</sup>

Thus, to provide comfort to both the regulator and the industry generally, some additional measures have been put in place by some *takāful* operators to meet solvency

<sup>6</sup> See IFSB, (2008) position paper: Solvency requirements for *takāful* operations, p 5.

<sup>7</sup> Engku Rabia Adawiyah Engku Ali, “Solvency of *Takāful* Fund”, in IFSB, (2011) pp 24-26.

requirements of *takāful* funds. These measures normally involve the *takāful* operators using their shareholders' funds to provide financial backing to support the solvency of *takāful* funds through the practices of:

- *qarḍ* (interest-free loan) to make good any deficit in the *takāful* funds;
- Injection of assets into the *takāful* funds; and
- Allocation of assets in the shareholders' fund to cover any deficit in the *takāful* funds.

However, the *takāful* operators are also bound to consider other factors in their management of solvency of *takāful* funds, such as, fiduciary duties and any possible conflicts of interest, pricing, risk management, business strategies, etc. They must also ensure good governance, especially in terms of segregation of funds and monitoring the role of appointed actuary. In this regard, it may be ideal for the *takāful* operator to allow for participants' representation in their management team, or in the board of directors.

In this sense, it can be said that the regulation of *takāful* seems to combine the features of mutual /cooperative insurance and those of commercial insurance. This approach is considered necessary, based on policy consideration, to cater for the specific features and characteristics of *takāful*.<sup>8</sup>

However, the terms and conditions of *qarḍ* on repayment and timing of the drawdown are unclear and not stipulated. The technical aspect of *qarḍ* that has to be kept in mind is how to maintain fairness between different generations of participants, in particular future generations i.e. *takāful* participants that newly joined a pool in a solvent position (without drawdown of the *qarḍ* facility) will be negatively affected as they might have to pay higher contributions or receive a smaller or no share of the underwriting surplus due to the need to make repayments of the *qarḍ*. There will be an obvious risk that *takāful* participants may decide to leave the fund once the fund is in a deficiency if they are facing higher contributions or cannot expect to receive any underwriting surplus at the end of the *takāful* contract. Hence, it might be difficult to convince any potential *takāful* participants to join a pool that is in a technical deficiency i.e. below the solvency requirements. It is important to point out that according to the Sharī'ah the setting of contribution levels so as to repay a *qarḍ* must not result in a higher fee or other remuneration for the *takāful* operator, as this would defeat the requirement that *qarḍ* be a benevolent or interest free loan.

In short, all the above arrangements involve the *takāful* operators using their own shareholders' capital to support the solvency of *takāful* funds. A relevant question that arises here is: what is the Islamic juristic position on the imposition of a duty on the *takāful* operator to financially support the solvency of *takāful* funds in the above manners? However before getting into the Sharī'ah position on this issue, it is imperative to examine the details of *qarḍ* and its legal basis in Islamic law.

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<sup>8</sup> Ibid, p 26.

## 6. The Concept of *Qarḍ* Facility

The Sharī'ah law allows *qarḍ* facility as a form of financial services for the shareholders in *takāful* undertaking to help and protect *takāful* participants when the *takāful* fund is in deficit and those who are in need of financial assistance. *qarḍ* in Sharī'ah may be obtained in two ways: (i) *qarḍ* with condition of repayment, and (ii) gratuitous loan without any compensation (*qarḍ hassan*). However, Sharī'ah does not recognize any loan with interest for the benefit of the debtor. It only recognizes gratuitous *qarḍ* or better known as *al-qarḍ al-ḥasan*, but this term is the terminology used in the holy Qur'ān. It is stated in the Holy Qur'ān: "...give regular charity; and loan to Allah a beautiful loan" (*Al-Muzamil*: 30). Therefore, the *qarḍ hassan* is the term used in the holy Qur'ān and such term cannot be used in institutions offering Islamic financial services; which indicate that *qarḍ* is charity not financial assistance.

### 6.1 Definition of *Qarḍ*

The *qarḍ* has been defined in the IFSB-1 (2005) on Capital adequacy standard as a contract to provide amounts of loan (interest free) to others intended to allow the borrower to use the loaned funds for a period with the understanding that the same amount be repaid at the end of the period.<sup>9</sup>

Al-Zuhaili (1985) also defined *qarḍ* as a specific contract to pay the money (interest free loan) to another that the same amount be repaid at the end of the contract".<sup>10</sup>

The AAOIFI has defined *qarḍ* as "the transfer of ownership in fungible wealth to a person on whom it is binding to return wealth similar to it".<sup>11</sup>

Therefore, *qarḍ* is a kind of gratuitous loan given to the needy people for a fixed period without requiring the payment of interest or profit. The receiver of *qarḍ al-ḥasan* is only required to repay the original amount of the loan.

### 6.2 Objectives of *Qarḍ* Facility

Sharia'h emphasizes to make brotherhood among the Muslims. The main principle of brotherhood is to care and share each other. *Qarḍ* being a loan (without interest) can help the fellow muslim brothers who need money but do not have it at present. Thus, *qarḍ* facility enhances brotherhood among the Muslims. The main objectives of *qarḍ al-ḥasan* are:

- To establish better relationship between shareholders, *takāful* operators and the *takāful* participants.
- The mobilization of saving from all people in the society.

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<sup>9</sup> See IFSB-2 for more details

<sup>10</sup> See: Al-Zuhaili (1985), Vol-5, p 3785.

<sup>11</sup> See: Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), (2010), Sharī'ah Standard for Islamic Financial Institutions No 19, p 347

- To perform a good deed that is encouraged and appreciated by the Almighty Allah and His messenger.
- To strengthen the global *takāful* industry and Islamic finance in general.

### 6.3 *Qarḍ* in *Qur'ān* and *Sunnah*

In many places of the Holy Qur'ān, Allah has mentioned and encouraged *qarḍ* by assuring better reward in this world and in the Hereafter. In Qur'ān Allah says, "Who is it that will give Allah *qarḍ al ḥasan*, which Allah will double into his credit and multiply many times." [Al-Baqarah: 245]

The Qur'ān says:

"If you give Allah *qarḍ al-ḥasan*. He will double it to your credit and he will grant you forgiveness." (Al-Tagabun: 17)

In the Ḥadīth

The *Sunnah* of the Prophet (peace be upon him) is also very clear on this issue. In Ḥadīth reported by Abu Hurayrah, the Prophet (peace be upon him) said, "Whoever relieves a believer from a difficulty in this world, Allah will relieve him from his difficulty and Allah will facilitate him in this world and world hereafter." [Sahih Muslim, Ḥadīth No 239]

The above Qur'ānic verses and Ḥadīth directly and indirectly encourage giving *qarḍ* in general which includes giving *qarḍ* facility to the *takāful* participants or anybody who is facing financial difficulties. This will add to the credits of a Muslim in manifold and bring forgiveness for him in this life and hereafter.

## 7. Sharī'ah Ruling of *Qarḍ* Facility in *Takāful* Undertaking

This paper does not intend to give an elaborate examination of these interpretations and arguments on the *qarḍ* facility. Direct reference can be made to the original writings on the matter by those who need more elaboration. What the paper will do is just to highlight the various interpretations as given by the scholars and the effects of each of these interpretations on the issue of ownership of *takāful* funds and responsibility for their solvency. *Qarḍ* facility, being a contract between two parties requires some Sharī'ah rules and principles which are applicable for other Islamic financial transactions. These rules and principles are as follows:

### 7.1 Both Parties Should Be Legally (Sharī'ah) Capable to Enter Into the Qarḍ Contract.

It is unanimously agreed by the four schools of law that to enter into a contract, parties should be mature (*baligh*), have reason (*'aqil*) and *rashid* (major with sound judgment). In the holy Qur'ān, Allah says:

“Make trial of orphans until they reach the age of marriage; if then you find sound judgment in them, release their property to them” [Al-Nisa: 6].

This verse states that the age of marriage and the sound judgment is the age of maturity. Thus, a matured person is capable to enter into any transaction and the contract or transaction is considered valid.

In Ḥadīth of the prophet, it is states that:

The Prophet (peace be upon him) said, "The pen is raised for three groups (of people) that is, they will not be responsible for their actions: the insane until they become sane, those who are sleeping until they are awoken, and the youth until they reach puberty". (Sahih Muslim, Ḥadīth No 319)

The above Ḥadīth makes it clear that a person who has not attained the age of puberty may not be a responsible party in any contract or any transaction particularly *qarḍ* contract.

### 7.2 *Ijab (offer) and Qabul (acceptance) of the Qarḍ Must be Clearly Made Before Entering into the Loan Contract*

All four schools of thoughts agree upon that *ijab* and *qabul* should be clearly indicated in the contract, otherwise, the loan contract may create dispute in future. In the loan agreement, there should have clear expression, collation and conjunction of the *ijab* and *qabul* between the parties.<sup>12</sup>

### 7.3 *The Date of Payment for Qarḍ Facility Must Be Specified*

It is also agreed among the Muslim jurists that the date of payment should be mentioned in the *qarḍ* agreement. If no date is specified between the *takāful* operators and *takāful* participants, the transaction may lead to ambiguity and dispute in future among the shareholders and the *takāful* participants.

The basis for the above Sharī'ah ruling means that paying the *qarḍ* facility in time as specified in the contract which cannot be subordinated is that it was based on the *qarḍ* agreement of the Prophet's companions. When the Prophet migrated to Madinah, he was informed that contracts of *salam* were made without stating specified time or amount.

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<sup>12</sup> See: Al-Zuhaili (1985), vol-5, pp 3785-3789.

This is the analogy to show that in any contract specification of time is very significant, the prophet said:<sup>13</sup>

“whoever enters into a contract of salam should specify the date of delivery and the amount of subject matter” (Narrated by Bukhari and Muslim)

#### 7.4 *The Qarḍ Contract Should be Written Down*

This ruling is based on a Qur’ānic injunction. As Allah (s.w.t) says; "O you who believe! When you deal with each other in transactions involving future obligations for a fixed period of time reduce them in writing." [Al-Baqarah: 282]

Muslim jurists, however, differ on this condition. Majority of the muslim jurists argue that it is not obligatory but strongly recommended. The reason given by them is that if both parties agree not to write, then it is no longer an obligation upon them to write down. The wisdom behind the writing down is to avoid future dispute. On the contrary, minority of the Muslim jurists like *al-Tabari* are of the opinion that it is obligatory upon the parties to write down the contract. It is submitted that the majority's stand seems more reasonable as they have given the option upon the parties whether to write it down or not.<sup>14</sup>

#### 7.5 *Getting Two Witnesses*

The Qura'nic injunction is that there must have two male witnesses, if two men are not available, then one man and two women will have the same effect. As the Qur'an says:

"And get two witnesses out of your own men and if there are not two men, then a man and two women" [Al-Baqarah (2): 282].

It is very essential for the loan contract to be complied with this Qur’ānic requirement to avoid future disputes.

#### 7.6 *Extra Payment*

It is very clear that in the *qarḍ* agreement, there will be no condition for extra payment; otherwise, it will be *ribā*. It is however, advisable for the debtor to give some sort of gift to the creditor as a sign of appreciation of his voluntary deed.

In a Ḥadīth, Jabir bin Abdullah (may Allah be pleased with him) reported that I had the right (of *qarḍ*) on the Messenger of Allah, he had settled it and made additional payment to me. Again Abu Rafi' reported that the Prophet (saw) had borrowed a young female camel from someone and when he received zakat of camels, he ordered me to send a young female camel to the man as settlement of the loan. I said to him, "I could not find among the camels except a female camel which is ready for pregnancy". The Prophet (peace be upon him) said, "give it to him,

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<sup>13</sup> Ibid, p 3789

<sup>14</sup> See: Al-Zuhaili (1985), vol-5, p 3785.

indeed, the good person among you is he who settles *qarḍ* with something better". (Sahih Muslim, Ḥadīth no 231)

This in fact is not regarded as doubt as to its chain of narrators. Moreover, Muslim jurists have various opinions relating to extra payment over *qarḍ*. The Hanafi, the Shafi'e and the Hambali's stand is that every loan with profit is forbidden because of the statement "every *qarḍ* which draws benefit is *ribā*" if the profit is stipulated in the loan agreement, otherwise, the profit is permitted.<sup>15</sup> According to Malikis, the borrower may pay more than the capital quantitatively or qualitatively at the time of the settlement of the *qarḍ* provided that the *qarḍ* was used for commercial purpose. They restricted the extra benefit from the *qarḍ* if it was used for consumption purpose.

#### 7.7 Early Demand to Pay Back

*Qarḍ* facility is a voluntary act by the creditor. However, it is not encouraged for early demand to pay back the *qarḍ* from the debtor. In the Holy Qur'an Allah says: O you, who believe, fulfil your contract. [Al-Maidah:1]

The Qur'ānic and the Ḥadīth injunctions indirectly provide that the creditor should not demand the loan amount from the debtor before the agreement matures or lapses. Muslim jurists, however, have given different views on this matter. According to the Shafi'e and the Hambali jurists, the creditor can demand the settlement from the debtor before the expiry period as he wishes. They have given the reason that the loan is voluntary and it cannot compel any party to abide it. The Hanafi and the Maliki jurists, on the contrary, are of the views that the creditor cannot demand the loan amount back until the time for settlement matures.

### 8. Shari'ah Views on Case of Subordinated *Qarḍ*

According to the Shari'ah principles, *takāful* operator is commonly expected to provide a *qarḍ* facility (interest free loan) in case of a deficit in the *takāful* fund and the repayment of *qarḍ* should be from future surplus arising from the *takāful* funds. The most obvious reasons why the *takāful* operator is expected to provide a *qarḍ* are twofold. Firstly, it is hardly practicable to ask each and every individual *takāful* participant to contribute more funds into a fund in deficit. Secondly, as the *takāful* operator being an agent of the pool shares the risk of a deficiency, this falls within the mandate of *takāful* operator. In this case subordinated *qarḍ* is "a process by which a creditor is placed in a lower priority for the collection of its *qarḍ* from its debtor" or "it means that the *qarḍ* providers (shareholders) have subordinate status in relationship to the *qarḍ* facility".<sup>16</sup> However, the Shari'ah position and juristic views on the case of subordinated *qarḍ* will be summarized in the following

Al Ashqar<sup>17</sup> is of the opinion that it is not permissible for Islamic insurance to undertake to cover deficit in the insurance fund from its shareholders' fund, even by way

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<sup>15</sup> See: *ibid*, p 3787.

<sup>16</sup> For more details see: <http://en.wikipedia.org/wiki/Subordination>, visited on 16 March 2012.

<sup>17</sup> See more details: Al-Ashqar, (1998), p 22-23.

of *qard*. But he allows for other means to cover the deficit i.e Islamic insurance reserves. He argued that the *takāful* company is a *muḍārib* in investing the *takāful* funds. Thus, when the company undertakes to give *qard* to the *takāful* funds in the event of deficit, this will amount to stipulating one contract in another contract, i.e., *muḍārabah* and loan; or *muḍārabah* and guarantee.

The argument by Al-Ashqar seems to apply to a situation where the *takāful* company is a *muḍārib*. The same argument may not apply where the *takāful* operators use *wakālah* contract in the management of *takāful* funds, which is the practice by many *takāful* companies.

In contrast, it is stated in the Sharīḥ standard for Islamic financial institutions No 26 issued by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)<sup>18</sup> that:

When the Islamic insurance assets along with indemnities received from re-insurance fall short of covering the indemnity commitments, the *takāful* operator may cover the deficit from project financing or *qard* (interest free loan) debited to the account of the *takāful* fund. In this regard, the deficits resulting from commitments of the current year may be covered from the surpluses of the succeeding years. The *Takāful* Operator (TO) may also claim settlement of the deficit from *takāful* participants if they undertake to do so in the *takāful* scheme.<sup>19</sup>

Dr. Engku Rabiah has explained that a view similar to that of AAOIFI had been expressed by the Shariah Advisory Council (SAC) of the Malaysian Central Bank on this issue. For example, in the 38<sup>th</sup> Meeting of the SAC, it decided that:

- In the event that the reserves are not sufficient to cover deficits in the Participants' Special Account (PSA),<sup>20</sup> then the *takāful* operator must cover the deficits by giving financial help from the shareholders' fund by way of *qard ḥasan*.

She said that the SAC had resolved in their 46<sup>th</sup> Meeting to:

- Approve the Central Bank of Malaysia's proposal to impose on the *takāful* operators the responsibility for the solvency of *takāful* funds and to secure the benefits and savings of the participants through asset injection from the shareholders' funds into the *takāful* funds to cover any deficit that occurs based on the reason given. The security and injection of asset may be implemented by the *takāful* operator based on commitment to donate (*iltizam bit tabarru'*), i.e., the operator undertakes to give donation to cover all the claims (liabilities) on the *Takāful* fund in the case of deficit.

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<sup>18</sup> See: Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), (2008), Sharīḥ Standard for Islamic Financial Institutions No 26, p 476

<sup>19</sup> See: AAOIFI, Sharīḥ Standard on Islamic Insurance, item 10/8

<sup>20</sup> Participants' Special Account (PSA) is the common name used in Malaysia to signify the risk /Tabarru' account in family *takāful* plans. This account is considered as the "*takāful* fund" to cover for claims.

There are some regulators that are of the view that the *qard* can be subordinated. While a *takāful* firm or *takāful* operator may exclude from its fund liabilities any amounts borrowed from the *takāful* fund so long as the following conditions are met:<sup>21</sup>

- The loans are free loans, established in accordance with Islamic principles, and the Shari‘ah Supervisory Board (SSB) approves the terms and conditions of those loans.
- The loans rank for repayment upon winding up of the *takāful* company only ahead of the ordinary shares of the company and, for the avoidance of doubt, must be subordinated to all participants and other creditor obligations of the *takāful* fund.

It is also explained that the *takāful* undertaking allows for the capital to be contributed to the risk fund in the form of *qard* facility. From the point of view of risk fund, since there is a separation between the *takāful* operator’s fund and the fund as explained earlier, *qard* facility received might be viewed as capital in the risk fund, provided that is appropriately subordinated to the need to meet claims and can only be repaid out of future surplus. To avoid so called “double gearing” using the same capital to cover two different risks, if *qard* facility represented capital in the risk fund it could not also be recorded as an asset in the *takāful* operator’s fund even though it is expected to be repaid.<sup>22</sup>

This regulatory position is contradicted with Shari‘ah rules and principles based on the *qard* contract which will be discussed in details below. Sobia Maqbool<sup>23</sup> has already argued her speech that subordinated *qard* is not allowed in Malaysia; as for *takāful* solvency requirements she explained, “The relative priority of claim of *qard* offered by the SHF vis-à-vis other obligations, is also an important rating factor. For instance in Malaysia, *qard* facility is not explicitly subordinated to the interests of policyholders (*takāful* participants). In Pakistan, however, this is not the case as the company is only required to pay *qard* from underwriting surplus. This is considered positively as underwriting surplus is arrived at after taking all claim expenses as well as associated reinsurance costs/benefits into account”<sup>24</sup>.

Unlike conventional insurance, any surplus generated within the PIF is shared with the participants, which may prevent capital formation. Therefore, policy with respect to creation of surplus equalization reserve is considered important in terms of future assessment of claims paying ability. This reserve would only gradually grow upon time, depending upon the policy adopted by the *takāful* operator and any credit thereof is built accordingly into ratings. In view of the practice of distributing surplus, the claims paying ability strictly from the PIF perspective may actually vary significantly from year-to-year and undertaking a firm-wide capitalization analysis therefore makes more sense. It is also

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<sup>21</sup> See: Central Bank of Bahrain Rulebook, (2005), Capital Adequacy Module, CA-8.4.10 volume 3, 23-25.

<sup>22</sup> James Smith, (2009), p. 230-240.

<sup>23</sup> Sobia Maqbool’s opening speech, (2008), Rating Agencies Methodologies for *takāful* and *Re-takāful* Firms, JCR-VIS Credit Rating Company Limited, p 2-4

<sup>24</sup> See Tobias Frenz & Younes Soualhi (2010), *Takāful* and *Retakāful*: Advanced Principles and Practices, (Malaysia: Kuala Lumpur IBFIM, 2 edition), pp 204-209.

considers the extent of ring-fencing amongst the surpluses generated by various product lines and the degree to which surplus from one may be used to off-set the losses on others. A more rigid structure may result in a greater need to call for capital from the SHF and may not be viewed positively.

The IFSB-11 has explained that *qard* facility cannot be subordinated in the *takāful* undertakings. This is because the extent to which a *Qard* facility enables a *takāful* undertaking to meet regulatory solvency requirements depends, inter alia, on the terms on which such *qard* facilities are made available by *takāful* operators. This depends in the light of the regulations in a particular jurisdiction, including, in particular, those that determine the status of an outstanding amount of a *qard* facility (that has already been drawn down as a *qard*) in the case where a PRF enters into an insolvent winding-up.<sup>25</sup> In such a case, there are two possible scenarios:

- i. Any outstanding *qard* would rank *pari passu* with participants' claims, so that the deficiency would be shared pro rata;
- ii. Participants' claims would rank above any outstanding *qard*

Only in the second case should the *qard* facility be considered to be fully part of regulatory capital. In the first case, it might be considered as making some contribution to regulatory capital.

Therefore, in order to know Shari'ah position on subordinated *qard* the IFSB-11 further emphasized that in order for a *qard* facility or *qard* to be accepted for solvency purposes, supervisory authorities should satisfy themselves that the following conditions are met:<sup>26</sup>

- (i) the *qard* facility provided to a PRF cannot be withdrawn by the *takāful* operator before the PRF is considered to meet solvency requirements independently of any *qard* facility;
- (ii) the *takāful* operator has given its consent to the supervisory authority that, in a winding-up situation, it will treat any part of the *qard* facility that has been drawn down as a *qard* as being donated to the PRF to the extent that is necessary in order for participants' claims to be in accordance with regulatory obligations (or some other arrangement to the same effect).

However, Elgari in his paper (2009) "*qard* facility in *takāful* fund" delivered in the IFSB seminar on Shari'ah issues related to *takāful* undertakings in Madinah stated:

Origin of *takāful* fund above is that this fund belongs to *takāful* participants. Therefore, *takāful* participants have to bear or be responsible for paying back the shareholders this amount. Elgari (2009) explained that what if the deficiency in the *takāful* fund is still continuing which leads to a winding up. According to

<sup>25</sup> IFSB-11 (2010), Standard Solvency requirements for *takāful* (Islamic insurance) undertakings, p 2-12.

<sup>26</sup> See: IFSB-11 (2010), Standard Solvency requirements for *takāful* (Islamic insurance) undertakings, p 14

him: If this is what happens to this fund, in the event of a continued deficit, the *takāful* operators or shareholders have the right to forgo or donate this *qard* facility for the benefit of *takāful* participants, this will show the meaning of cooperative which is the core principles of *takāful* undertaking. There is no restriction from Sharī‘ah rules and principles, it is permissible.

## 8. Conclusion

Upon the discussion on the *takāful* fund and the case of subordination *qard* in this paper we have concluded on the following:

1. There are two elements important in formulating the solvency requirements of a *takāful* undertaking namely the *takāful* fund and *qard* facility.
2. Sharī‘ah attempts to establish justice and eliminate exploitation in the society and prevent the accumulation of wealth in the hands of few people. Therefore, Sharī‘ah absolutely prohibits usury (*ribā*) as it is the root of all injustices in the financial transactions. *Qard* facility, on the contrary, being an interest free loan which is among the Sharī‘ah compliant contracts adopted in Islamic finance and *takāful* industry. The Qur‘ān and the *Sunnah* have much appreciated and encouraged giving *qard*.
3. The treatment of the *qard* facility is a fundamental issue. Any draw-down of a *qard* facility into a participants’ risk fund (PRF) should in principle be repaid from future surpluses of the PRF and should not be subordinated as mentioned. The draw-down of the *qard* facility will have been initiated with the intent of enabling the PRF to meet its regulatory obligations.
4. The IFSB-11 stated that *qard* cannot be subordinated and any outstanding *qard* would rank *pari passu* with participants’ claims, so that the deficiency would be shared pro rata; and participants’ claims would rank above any outstanding *qard*.
5. The *qard* facility provided to a PRF cannot be withdrawn by the *takāful* operator before the PRF is considered to meet solvency requirements independently of any *qard* facility;
6. The *takāful* operator has given its consent to the supervisory authority that, in a winding-up situation, it will treat any part of the *qard* facility that has been drawn down as a *qard* as being donated to the PRF to the extent that is necessary in order for participants’ claims to be in accordance with regulatory obligations (or some other arrangement to the same effect).

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