

## The Treatment of qarḍ (qarḍ facility) for Solvency of Takāful Fund in A Takāful Undertaking

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### Abstract

Solvency of takāful fund and mechanism for providing financial support towards the solvency of the takāful funds are two important elements in formulating the solvency requirements of a takāful undertaking (TU). The supervisor may require a takāful operator to extend qarḍ and earmarked qarḍ facilities, to takāful fund in deficit or shortfall giving rise to issues regarding the measurement of qarḍ for general purpose and prudential reporting. This paper reviews different views on the nature and measurement basis for qarḍ, including qarḍ facility assigned or allocation of assets in the shareholding to the takāful funds. This paper explores the recent Sharī'ah rulings on the supervisory requirement of the takāful operator obligations to financially support the solvency of takāful funds extend qarḍ and earmarked qarḍ facilities. In addition, qualitative method is applied as the paper provides a review of the nature of qarḍ (i.e. subordination) and Sharī'ah rulings and its position on the requirement to financially support the solvency of takāful funds. As the result, this paper is expected to provide useful insights to the supervisors with regard to the selection of measurement models and treatment of various funds over the interpretation and application of IFRS 17 to takāful industry.

**Keywords:** Solvency, takāful undertaking, qarḍ facility, surplus distribution.

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**Introduction:** Takāful is a form of financial protection, sometimes described as “Islamic insurance”, whose contracts and operations are expected to be in compliance with Shari’ah rules and principles. Similar to conventional insurers, takāful contracts/policies offers protection to consumers and businesses against unexpected events through the pooling of risk, and thanks to the law of large numbers. Risk pooling harnesses the power of the group to eliminate financial volatility for the participants (IFSB-11, 2010). On the other hand, Al-Qaraḍāwī (2012) and Ali et. al., (2015) defined takāful is established on the concepts of tabarru’ (donation) and ta’āwun (mutual cooperation) (IFSB-8, 2009). Thus, in AAOIFI Exposure Draft F2/2021, takāful contracts/policies represent a promise to pay benefits to participants against losses upon realisation of a defined event; participants in turn must make upfront payments (in form of contributions/tabarru’) to insurers.

In the AAOIFI regulations FAS 12 and FAS 13 (2008), a takāful operator is faced with uncertainties relating to the timing and magnitude of future losses and the risk that the contributions/tabarru’ charged and the reserves held will be insufficient to cover the losses. In managing these uncertainties, a takāful operator must hold sufficient financial resources to deliver on its promise even under adverse conditions, which the technical provisions are unable to cover. Moreover, supervisory authorities as protectors of participants’ interests, play an important role in ensuring that takāful operators have sufficient financial resources to provide for the appropriate level of protection to the participants. Consequently, supervisory authorities<sup>1</sup> across various jurisdictions have established their own capital requirements framework or regime over time, which require takāful operators to hold sufficient capital to withstand unforeseen and provide for degrees of supervisory intervention.

Thus, according to De Haan and Kakes (2010), the value of an operator’s promise to takāful participants depend on the amount of the capital that it holds because this provides assurance to the participants of its capacity to make all loss payments even if these are

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<sup>1</sup> For instance: Central Bank of Bahrain and Qatar Financial Centre Regulatory Authority, “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”, 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”.

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greater than expected. Butsic (1994) asserted that takāful operators are therefore, required to hold sufficient capital to maintain the firm default value at an acceptable level of confidence.

However, the two-tiered structure of takāful undertakings, where funds are segregated introduces issues with regard to the assessment of capital requirements for takāful undertakings. Therefore, the approaches to capital requirements for takāful undertakings differs in some respect as compared to conventional insurance. Typically, a takāful undertaking operates with two funds, the takāful fund and the TO's shareholders' fund, while in family takāful there is normally a savings component, the participants' investment fund (PIF). The takāful fund bears the risk fund of general takāful, such as motor vehicle, shipping and construction; or family takāful, such as education, health and annuity plans. Since these are separated, the assessments of the capital requirements are made separately for each fund.

A takāful fund has little or no independent means of raising capital to enable it to meet an initial capital requirement or to ease capital strain later. In most cases, it may take many years, for some product lines, before a fund begins to generate surpluses. While a takāful operator would certainly like to recover qarḍ<sup>2</sup> in future, having to top-up a participants' fund is part and parcel of the operator's duties and it is thus a cost of undertaking a takāful business. This is particularly in line with the classical Sharī'ah view on qarḍ ḥasan, a benevolent interest-free loan, which is while repayment is welcome, it is not expected (Asian-Oceanian Standard-setters Group (AOSSG), 2010).

For consumer protection, supervisors in many jurisdictions, including Malaysia, require a takāful operator to provide financial support (usually through qarḍ) to a deficient fund. This would prevent the moral hazard of a takāful operator continuing to enjoy fees irrespective of the health of its participants' funds, whilst an insurance company in a similar situation would bear its policyholders' deficiencies. This requirement gives rise to issues regarding the measurement of qarḍ for general purpose and prudential reporting.

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<sup>2</sup> Qarḍ refers to qarḍ without interest.

### **Research Objectives**

Given that, the context and purpose of the measurement of assets and liabilities of a takāful undertaking (TU) are key factors in determining the values that should be placed on them, which in turn highlights the importance of capital in TU valuations and reporting for solvency purpose. This paper has the following objectives:

- i. Reviews different views on the nature and measurement basis for qard, including qard facility assigned or allocation of assets in the shareholding to the takāful funds.
- ii. Explore the recent Sharī'ah rulings on the supervisory requirement of the takāful operator obligations to financially support the solvency of takāful funds extend qard and earmarked qard facilities.

### **Research Methodology**

This paper will use the qualitative research method to answer the objectives stated earlier. Qualitative research method is supported by secondary data via document analysis on the nature of qard (i.e. subordination) and Sharī'ah rulings and its position on the requirement to financially support the solvency of takāful funds. This paper is classified into explorative and descriptive research design. The exploratory study is generally intended to explore new insights on the treatment of qard (qard facility) for solvency of takāful fund in a takāful undertaking (TU). This paper describes and reviews secondary data to gather information related to research objectives which are primarily found in both printed and digital manuscripts through a systematic literature review. The data will be integrated wisely to provide a good finding analysis. Nevertheless, due considerations is given to relevant studies and publications issued by bodies concerned with takāful sector regulations and supervision, namely Islamic Financial Services Board (IFSB), and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), including publications from national takāful supervisory authorities i.e. Takaful Operational Framework (TOF) is reviewed.

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**Observation and Findings on the Treatment of Qard (Qard Facility) for Solvency of Takāful Fund in a Takāful Undertaking**

A solvency deficit occurs when a fund is in deficit if all claims needed to be paid out at that moment. In the event of deficiency in the takaful funds, it may be temporarily funded either by shareholders or takaful operator will provide qard (loan) to rectify the deficiency.

Under Section 95 of the IFSA imposes an obligation on a licensed takaful operator to provide qard on the takaful fund which would include PRF, from the shareholders fund for an amount and on such terms and conditions as may be specified by the Bank. The application called as qard ḥasan loan which no interest involved. Nevertheless, the SAC of BNM resolved that General PRF cannot be used to cover deficit in the Family PRF and vice versa.

There are two elements important in formulating the solvency requirements of a takaful undertaking namely the takaful fund and qard 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.

The SAC, in its 38th meeting dated 28 August 2003, 46th meeting dated 28 October 2004 and 62<sup>nd</sup> meeting dated 4 October 2006, resolved the following:

1. The takaful company shall be responsible for any insufficiency of the participant's risk fund on the basis of qard and
2. The takaful company shall make an outright transfer from the shareholder fund to the participant risk fund in the event that the deficit is still persistent and is due to mismanagement of the participant's risk fund (PRF).

The stipulated Shariah ruling for valid use of qard for solvency purpose as below:

1. The SAC resolution has considered that the qard from shareholders fund is an interest free loan and in line with Sharī'ah principles. As an entity entrusted to manage the takaful operation, it is art of the takaful company's responsibility to give qard in the event of deficit in the participant's risk fund. The application of qard in this context does not contradict with

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Sharī'ah principle since it is payable from the participants' risk fund in the future.

2. Besides, the SAC resolution has considered if the other preliminary measure, including qarḍ, are unable to cover the deficit in the participant risk fund and outright transfer would be the final solution. From the siyāsah Shar'iyah perspective, it is prudent precautionary as a whole. This is in line with the following legal maxim: "*Public interest is given priority over specific interest*", and "*Harm must be removed.*"

Due to an increased risk of insolvency and a potential threat to consumers' confidence in the industry, guidelines that recognise the specific structures and processes of Takāful undertakings are recommended for effective and efficient operation of these undertakings (IFSB, 2018).

### **Qarḍ Facility (Loan Provision) in Takāful Undertakings and Subordination of Qarḍ**

A qarḍ (loan) can be used as a tool to address solvency issues that may arise in a takāful fund i.e. for temporary qarḍ facility, IFSB (2021) stated that TO may provide qarḍ out of the shareholders' fund, or procure from a third party, which is to be repaid out of future surpluses. However, there are certain stipulated Sharī'ah rulings that must be followed to ensure that the use of qarḍ is in compliance with Islamic principles.

Qarḍ facility (loan provision) is crucial in the system to maintain its solvency. Qarḍ facility is offered due to (1) short term liquidity purpose in case of a deficit in the *takāful* participants' risk fund (PRF) and the repayment of *qarḍ* should be from future surplus arising from the *takāful* funds, or (2) it is offered as capital resource (BNM, 2014) when there is insufficient fund during capital adequacy or solvency assessment, so the qarḍ must be subordinated for it to be qualified, it must be lower to policyholder in rank during insolvency or winding up.

It is acceptable to subordinate qarḍ in the case of deficit, deficiency or drawn down of Takāful fund, as long as the qarḍ loan is given on an interest-free basis, and with the intention to assist the fund in meeting its obligations. The loan should be clearly specified, and the

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terms and conditions of repayment clearly agreed upon by the parties<sup>3</sup>. In addition, the loan must not be used to finance any speculative or non-Sharī'ah compliant activities.

The takāful company shall make an outright transfer from the shareholders' fund (SHF) to the takāful fund in the event the deficit. Hence, qarḍ is a subordinated loan from takāful operator to the takāful fund to cover instances when liabilities exceed assets. Method to measure qarḍ transaction between shareholders' fund and takāful fund has been ruled by SAC under MFRS 17 Insurance Contracts and MFRS 9 Financial Instrument Requirements.

Qarḍ is to be repaid from excess assets over liabilities but based on the ruling, the total repayment of the qarḍ amount will not increase even if the time value of money (TVM) principle is applied in the measurement method.

Islamic insurance assets along with indemnities received from reinsurance fall short of covering the indemnity commitments, the *takāful* operator may cover the deficit from project financing or *qarḍ* (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 (AAOIFI, 2008).

Qarḍ from the shareholders' fund (SHF) is an interest free loan in line with Sharī'ah principle. As an entity entrusted to manage the takāful operation, it is part of the takāful company responsibility to provide qarḍ facility in the event of deficit. Qarḍ in this context does not contradict Sharī'ah principle since it is payable from the participant's risk fund (PRF) underwriting surpluses of the succeeding years.

Qarḍ is to be counted a condition of treatment as capital to be subordinated, rather than a regulatory requirement for qarḍ (IFSB, 2021). The subordination is a voluntary act by the muqrīḍ (creditor) i.e. where capital resources within the Shareholders' Fund (SHF) are

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<sup>3</sup> According to the Shāfi'i and the Ḥanbalī jurists, the creditor can demand the settlement from the debtor before the expiry period as he wishes due to the fact that the loan is done voluntarily. The Ḥanafī and the Mālikī jurists, on the contrary, are of the views that the creditor cannot demand the loan amount back until the time for settlement matures.

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earmarked for potential provision as qarḍ to offer liquidity support to another fund. SAC had resolved in their 46<sup>th</sup> meeting that the security and injection of asset may be implemented by the *TO* based on *iltizām bil al-tabarru'* (commitment to donate), i.e., the operator undertakes to donate to cover the claims and liabilities on the *Takāful* fund in the case of deficit to handle the risk of insolvency.

However, a qarḍ that is used for valid solvency purposes should be treated as a last resort, after all other options have been exhausted i.e. the *TO* must discover other avenues and possibilities such as increasing takaful contribution, reducing expenses, or restructuring the fund, before resorting to qarḍ. The *TO* must have an obligation to repay the qarḍ, regardless of the financial performance of the fund. Hence, *TU* must be based on realistic expectations of recovery rather than assuming that such surplus would arise to reflect the perceived ability of the fund to repay the qarḍ.

Some of the factors that militate against the solvency and underwriting capability of the takāful fund are wakālah fees and profit-sharing ratios, and surplus distribution. Takaful is marketed on a basis of surplus distribution, if the fund carries a substantial debt to be repaid out of surpluses that would otherwise be attributable to the takaful participants, these potential takaful participants may be disinclined to subscribe to the fund. *TOF* (2019) stated that the policy must accommodate the issue of surplus distribution to participants during the period where qarḍ has not been fully repaid by the *PRF* e.g., whether the distribution of surplus is continued, reduced, or put on hold which shall be recommended by the Actuary and endorsed by the Board.

It is important to note that the qarḍ should only be used in exceptional circumstances, and its use should be temporary. From a Shari'ah perspective, it is permissible to subordinate qarḍ in the case of a deficit, deficiency or drawn down of the takāful fund. This is based on the principle of *ḍarūrah* (necessity) in Islamic jurisprudence which allows for concessions to be made in exceptional circumstances to prevent harm. However, this should follow the guidelines and conditions set by the Shari'ah ruling such as not exceeding the necessary amount, ensuring the qarḍ is repaid as soon as possible, and ensuring all other avenues for raising funds is exhausted. Hence, qarḍ from the shareholders' funds is allowable from the Shari'ah perspectives and it is payable from the participants' risk fund (*PRF*) future underwriting

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surpluses. It is acceptable for the Takāful operator to offer qarḍ out of the shareholders' fund (SHF) or acquire from a third party which is to be repaid out of surpluses of the subsequent years. The ruling is based on the secondary sources of Sharī'ah, which is *maṣāliḥ al-mursalāh* (*public interest*). There are two fiqh maxims that support the ruling, which are "Public interest is given priority over specific interest" and "Harm must be removed". Since this is a public interest related matter, and there will be harm done if there is a deficit in the takāful fund, the maxims can be as sources of reference. Hence, in the case of deficit, deficiency or drawn down of takāful fund, it is permissible to subordinate qarḍ from the shareholders' funds. This is to protect the interests of takāful participants by setting a high probability that a Takāful undertaking (TU) would be able to meet all its contractual obligations and commitments. However, if the deficiency in the *takāful* fund leads to a winding up, Elgari (2009) stated that the TO or shareholders have the right to forgo or donate this *qarḍ* facility for the benefit of *takāful* participants, to demonstrate cooperative which is the core principles of *takāful* undertaking.

**The Concept of Risk Sharing**

In Takāful, the concept of sharing risk is fundamental, and it is achieved through the creation of a Risk Fund, to which participants contribute their contributions, and from which claims are paid. However, in some cases, the Risk Fund may not be sufficient to cover all claims, and the TO may need to transfer or share some of its risk or liabilities with a Retakaful/ Retrocedent operator (RTO), in a process known as "retakaful retrocession"<sup>4</sup>. From the Sharī'ah perspective,

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<sup>4</sup> Retakaful like is built on the principles of cooperative and risk sharing as laid out in the objectives (*maqāṣid*) of Sharī'ah. In the Retakaful scope, the TO acts as an agent (*Wakīl*) for the RTO and managing the Retakaful funds on behalf of the RTO. As agent (*wakīl*) the TO is eligible to receive a fee (*ujrah*). If there is a claim, the TO will pay the claimant from the Takaful fund, and then seeks reimbursement from the RTO for its share of the liability. The RTO is required to pay the TO its share of the liability as agreed in the contract. The sharing of liabilities between the TO and RTO is based on the principles of *Muḍārabah* and *Wakālah*. The RTO assumes a portion of the risk and shares it with other RTOs, thereby diversifying the risk. The TO acts as an agent (*wakīl*) for the RTO and

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risk sharing is not with the RTOs but the Retakaful Fund (RTF) or Retakaful Risk Fund which is a pool of the ceded liabilities to TOs. Risk has capital charges i.e., every risk underwriting is associated with capital requirement. Capital resources available to Takaful Operators (TO) or Retakaful Operators (RTO) should be enough to cover the risk underwriting by TO or RTOs. Based on BNM stipulation, we have different composition of capital, which represents the ability of capital to absorb losses<sup>5</sup> in all circumstances.

Retakaful cessation is a mechanism where a takaful operator shares its risk and liabilities with a retakaful operator, which provides reinsurance cover for a fee or premium. The retakaful operator assumes a portion of the risk and liability, reducing the risk exposure of the takaful operator. This concept is permitted in Islam as illustrated in the Qur'anic verse "And cooperate in righteousness and piety, but do not cooperate in sin and aggression. And fear Allah; indeed, Allah is severe in penalty." (Al-Mā'idah 5:2)

The sharing of risk and liabilities between the parties is based on the principle of tabarru' (donation). Tabarru' refers to a voluntary contribution to a common fund for the purpose of mutual assistance and benefit and is translated in Surah Al-Insan, "And they give food in spite of love for it to the needy, the orphan, and the captive, [Saying], We feed you only for the countenance of Allah. We wish not from you reward or gratitude." (Surah Al-Insān, 76:8-9)

From a Sharī'ah perspective, the sharing of risk and liabilities between the Takaful operator and the Retakaful operator should be based on the principle of tabarru' (donation or gift), which is a fundamental concept in Takaful. This means that the TO should transfer the

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manages the Retakaful funds on behalf of the RTO. According to Hasan (2011), the reinsurance company is called retrocedent and the accepting reinsurer is a *retrocessionaire* i.e. the *retrocessionaire* may then reinsure its exposure to another *retrocessionaire*.

<sup>5</sup> Absorb losses on a going concern basis, in run-off, in winding-up and insolvency, subject to constraints of fund segregation (IFSB, 2021).

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risk to the RTO as a gift or donation, without any expectation of receiving anything in return. The RTO, in turn, should accept the gift and undertake the risk on behalf of the TO, without any expectation of receiving anything in return.

The Shari'ah evidence supporting this concept of sharing risk through tabarru'6 can be found in numerous quranic sources. For example, Allah states in the Qur'an, "And they give food despite love for it to the needy, the orphan, and the captive, saying, "We feed you only for the countenance of Allah. We wish not from you reward or gratitude" (76:8- 9). This verse emphasizes the concept of giving for the sake of Allah, without expecting any reward or gratitude in return. Similarly, the Prophet Muḥammad (ﷺ) emphasized that "The believers, in their love, mercy, and compassion for each other, are like a single body. If one part of the body is in pain, the rest of the body shares in the fever and sleeplessness" (Ṣaḥīḥ Bukhārī).

Based on these principles, the sharing of risk and liabilities between the TO and the RTO should be done in a transparent and equitable manner, without any element of ribā (interest) or gharar (ambiguity/ uncertainty7). The terms of the Retakaful agreement should be

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<sup>6</sup> Tabarru' contract is the basis to which takaful operator is obliged to cover the loss contingent upon a defined loss event. In addition, the expectation to a portion of any surplus generated is also contingent on whether there **is surplus or not in the risk fund** and at the same time, considering the **solvency status of the fund**. The expectation has been made already, but for the distribution is correct (meaning that the expectation shouldn't be made), it depends on the volume of risk covered and their amount pay out as claim (loss ratio). Tabarru' as the basis contract of Takaful indicates that the participant's claim on policy holder's fund is contingent on the occurrence of loss events according to the policy document/ contract document/ product document. Meaning that the liability has been established, that the claim must be paid accordingly in event of loss. Sheikh Siddiq al-Darīr who explained that takaful comprises two commitments, i.e., donation and indemnification, but the latter depends on the occurrence of specified hazards or perils.

<sup>7</sup> Uncertainty and ambiguity constitute the discomfort experienced due to any missing information with regard to either outcomes or probabilities. Refer to Golman, Russell, Nikolos Gurney, and George Loewenstein. "Information gaps for risk and ambiguity." *Psychological Review* 128, no. 1 (2021): 86. Uncertainty can be resulted from the unknown future outcomes or the behavior of the counterparty. Martinez-Correa, Jimmy.

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clearly defined and agreed upon by both parties and should be in compliance with Sharī'ah principles.

This sharing of risk is based on the principle of cooperation (ta'āwuḍ) in Islamic jurisprudence, which advocates for joint effort and support to achieve common goals. Juristic opinions differ on the permissibility of Retakaful, but many contemporary scholars permit it under certain conditions, such as ensuring the contracts used are Sharī'ah compliant and the operations are carried out in a transparent manner.

The basis from Sharī'ah Standard No. 41, AAOIFI 2010: The agreement among insurance companies, on behalf of the insurance funds under their management, to devise a mechanism for avoidance of part of the risks which the insurance funds may encounter. On the basis of such agreement, a re-insurance fund which has a distinct legal personality and independent financial liability is formed through making contributions out of the insurance funds paid by the insurance clients on the basis of donation. The re-insurance fund, thus formed, assumes the task of covering part of the risks encountered by the insurance funds.

### **Deficiency in Participants' Risk Fund (PRF) and Participants' Investment Fund (PIF) and its treatments**

There are various international standards, regulatory frameworks<sup>8</sup> and other literature that depict the components of surplus or deficit as guidance for industry practitioners. A solvency deficit in the PRF occurs when assets of the PRF are insufficient to meet the liabilities of the PRF, where assets and liabilities refer to the total assets of

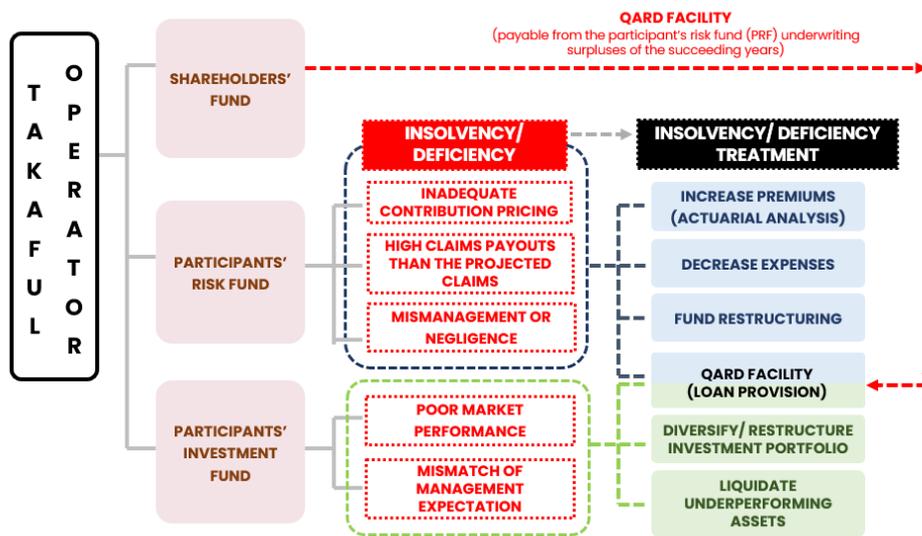
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*Decision under Risk, Uncertainty and Ambiguity: Theory and Experiments*, (Georgia State University, 2012).

<sup>8</sup> The IFSB (2010: 25), in its Standard on *Solvency Requirements for Takāful (Islamic Insurance) Undertakings*, and AAOIFI (2010), in its Financial Accounting Standards No. 13, on *Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies*.

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the PRF and the sum of actuarial liabilities and other liabilities of the PRF, respectively, as reported in the balance sheet of the takaful funds. TO shall immediately rectify the deficit via qard from SHF which shall be repaid from the excess of assets over liabilities arising in the PRF in the future years (BNM, 2013). Graph 1.0 illustrates on the treatment of qard (qard facility) for solvency of Takāful funds in Takāful is further explained in the paragraph below.



*Graph 1.0: The Treatment of Qard (Qard Facility) for Solvency of Takāful Funds in Takāful*  
 Source: Author's Own

The first scenario is deficit due to poor performance or low investment returns. As we are aware, Takaful contributions received from the participants will be invested in the various Sharī'ah compliant investment instruments in accordance with the investment objectives and liquidity requirements of the respective takaful funds. 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 (IFSB-8, 2009).

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If the unexpected low returns from the investment and deficit happened due to a mismatch of management expectation and market performance e.g. economic downturn, negative news on certain industry that leading to low or negative returned; or due to poor investment strategy. In such a situation, the TO can diversify its investment portfolio to mitigate the impact of poor performance or apply qarḍ facility. The TO may provide qarḍ to the TRF with qarḍ or a loan on a profit-and-loss sharing basis. The loan must not involve any interest, and any profit gained from the investment. It is the TOs' fiduciary duty to manage the investments in a sound and prudent manner, in line with Shari'ah requirements and participants' expectations to avoid adverse impact on the takaful funds (BNM 2013).

Decrease in the value of investments held by the TRF due to market fluctuations or poor performance. In this case, the TO may need to change the investment strategy by restructuring its investment portfolio or liquidating underperforming assets to address the deficit. For instance, in 2020, Takaful Emarat<sup>9</sup> had to adopt a conservative investment approach<sup>10</sup> to address a deficit in its risk fund caused by volatile market conditions. Hence, the financial reporting practices of TO should provide adequate information regarding the company's investment strategy, funds allocation, and revenue and expenses accruing to their particular investment funds.

The second scenario refers to TO experiences claims paid out higher than the projected claims or due to mismanagement or negligence, which leads to a deficit in the PRF, as discussed in SAC meeting dated 28 August 2003 and 1 May 2010.

This scenario happens when the deficit in PRF due to claim needs to be paid immediately. For example, the unfortunate incident

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<sup>9</sup> *Takaful Emarat Insurance PSC, established in 2008, is a Shari'ah-compliant Life, Health and General Takaful Insurance Provider in the UAE listed on the Dubai Financial Market (DFM).*

<sup>10</sup> *A conservative, or defensive, investment style is a low-risk investment strategy which focuses on preserving capital while generating income through low-risk investments.*

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of suffering a flood loss occurred in December 2021 due to unprecedented rainfall on the west coast of Peninsular Malaysia (MTA and PIAM, 2021). This led to businesses suspension for more than a week with an estimation of RM6.1 billion in financial losses. Many of the TO need to ease their consumers' financial burden by expediting their claims settlement with prudent underwriting and survey must be performed to evaluate the real risk involved at the scene. If the PRF incurs a deficit or loss due to unexpected high submission of claims due to an event beyond its control, such as natural calamities, climate crisis and perils, the TO may extend a qarḍ to the PRF to cover the deficit, this qarḍ is to be repaid out of future surpluses. Setting up a retakaful program to a desired risk appetite would also help reduce the risk of deficiency of the takāful funds.

In such a situation, the TO may increase premiums, reduce expenses or utilize qarḍ facility to cover the deficit. It is the TOs' fiduciary in managing the takāful funds, TOs are expected to set appropriate and adequate provisions for the takāful funds to meet future obligations (BNM, 2013). An example of the utilization of qarḍ facility to address the deficit in TRF is the case of Takāful Malaysia in 2020, where there was a deficit of RM 58.8 million in its general takāful fund due to a surge of claims related to COVID-19. To fill the deficit, Takāful Malaysia utilized a qarḍ facility of RM 100 million provided by its parent company, BIMB Holdings Berhad. The COVID-19 pandemic is a catastrophe, and the Malaysian TOs should have reserved for catastrophic risks which are above the Incurred But Not Reported (IBNR) claims reserve; or use a separate catastrophic reserve rather than incorporating into the IBNR reserves (Mahadi and Ismail, 2021). BNM has indirectly allowed takāful operators to incorporate catastrophic reserves (Bank Negara Malaysia, 2018 and 2019).

Deficit in the PRF is due to high claim payouts that exceed the contributions received where it leads to a deficit in the fund. In this case, the TO may need to inject additional funds into the risk fund to

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ensure there are sufficient reserves to meet future claims. For example, TOs in Malaysia can obtain qarḍ from the government-owned Takaful Malaysia or from Islamic banks to address solvency issues in their PRF. In 2019, Takaful Malaysia had to inject RM150 million into its risk fund to address deficits due to the underperformance of its Family Takaful business. It stated that the deficit was attributed to a combination of weaker than expected contributions and higher than expected claims. The injection of funds was aimed to strengthen the financial stability of the company and to maintain the solvency ratio at a comfortable level. This move was a proactive measure by Takaful Malaysia to ensure the continuity of its business operations and protect the interest of its policyholders.

Another instance is Jakel Group incident with preliminary estimated almost RM100 million in losses from the fire, which broke out at its three-storey outlet in Section 7, Shah Alam (NST, 2023). If only one takaful company has to paid all the claim might triggered to big loss hence the retakaful will lead to acquiring other operator to share its risk.

The third scenario refers to TO experiences inadequate pricing of contribution, which leads to a deficit in the PRF e.g., proposing a new medical coverage product<sup>11</sup> with adequate pricing may be relevant for the current year, but the performance of the product must be reviewed. In this circumstance, the TO may need to re-assess the pricing of contribution to ensure that they are adequate to cover the expected claims and expenses of the PRF, and the takāful products should be priced to include appropriate buffers or designed with flexible features which could absorb future fluctuations and uncertainties (BNM, 2013) on the timing of the risk and the volume of the claims. TO will determine the amount of contribution through actuarial estimation which involves lots of underlying assumptions.

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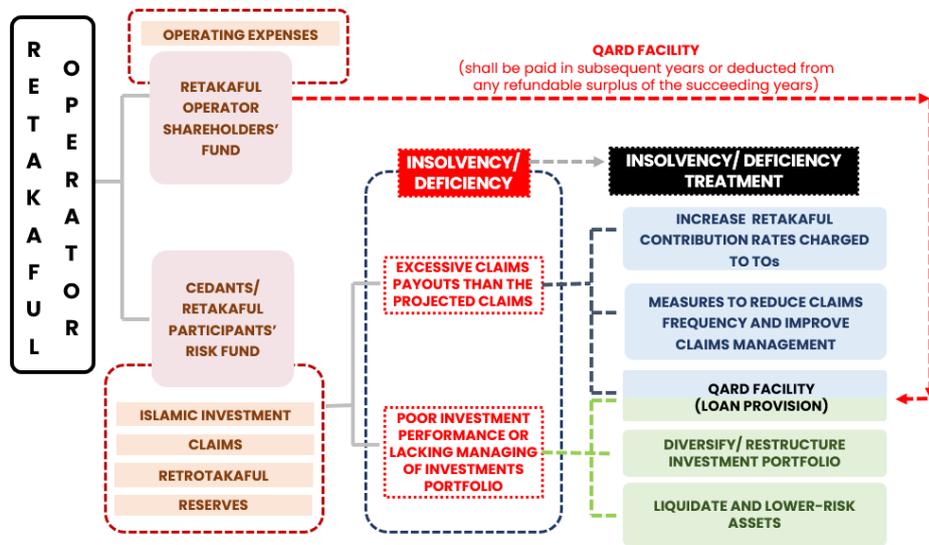
<sup>11</sup> Changes in the hospital services and supply costs will have a direct relation to the higher claim and may lead to a deficiency in takaful fund. Hence, TO must be vigilant to all sources of risks that can threaten the solvency of takaful fund.

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This may involve conducting an actuarial analysis to determine the appropriate level of contribution. Additionally, the TO may consider implementing risk management strategies, such as underwriting guidelines and claims management practices, to reduce the frequency and severity of claims.

**Deficiency In Retakaful Risk Fund and Its Treatments**

Graph 2.0 illustrates on the treatment of qard (qard facility) for solvency of Retakāful funds in Retakāful is further explained in the paragraph below.



*Graph 2.0: The Treatment of Qard (Qard Facility) for Solvency of Takāful Funds in Retakāful.*

*Source: Author's Own*

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The first scenario refers to RTO12 experiences a deficit in its Risk Fund due to high, severity of excessive claims frequency that exceeds tabarru' funds i.e., cedants / retakaful participants' risk fund. In this scenario, the Retakaful operator may need to implement various measures to reduce claims frequency and improve claims management. If the claim is higher than projected, RTO may need to increase the retakaful contribution rates charged to TOs, i.e., the RTO may adjust the retakaful pricing adequately to the latest risks trend during the retakaful renewal agreement. Besides, the RTO is required to adjust and endorse the contracts. This procedure is required to ensure that adequate prices quoted for the risks. In the event of running a deficit to the retakaful funds due to unforeseen claims by its participants, the retakaful operators provide a qarḍ (a loan injection into retakaful funds) to cover liability. The amount of the loan shall be paid in subsequent years or deducted from any refundable surplus of the succeeding years.

For example, in early 2023, an earthquake in Turkey<sup>13</sup> may disrupt the reinsurance and retakaful system in the country, which RTOs should study the risk appetite for the business taken and RTOs may seek retakaful retrocession to other RTOs to minimise the severity of impact. In the case of a TO in Malaysia during the Covid-19 crisis where majority of the takaful operators experienced a spike in claims due to Covid-19 infections and death. The risk fund was insufficient to cover the full amount of the claims, resulting in a deficit in the retakaful risk fund. To address the shortfall, the operator extended a qarḍ facility to the takaful fund and used the funds to cover the gap until the retakaful coverage was replenished. This helped to ensure that the takaful fund remained solvent and could meet its obligations to policyholders.

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<sup>12</sup> Retakaful can be operationalized based on similar structures implemented in Takaful either on al-Muḍārabah, al-Wakālah or hybrid models incorporating al-Muḍārabah and al-Wakālah.

<sup>13</sup> According to the World Bank (2023), an estimated USD 34 billion in direct physical damages and reconstruction will be potentially larger, and about 4% of Turkey's GDP may loss associated with the economic disruption from the earthquake.

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The second scenario refers to RTO experiencing a deficit in its risk fund due to poor investment performance or lacking managing of investments portfolio i.e., this happens when RTOs face deficits due to the fall in value of investment assets, leading to liquidation. For instance, in 2018, Hannover Re Takaful faced a net loss of RM 33.1 million due to investment losses, and in 2020, some RTOs in Malaysia experienced a deficit in their Risk Funds due to the impact of COVID-19 on financial markets. In response, they reviewed their investment policies and asset allocation strategies and made adjustments to ensure the long-term sustainability of the Retakaful fund to mitigate the impact of the losses.

In this scenario, the RTO may need to review its investment policies and asset allocation strategies to ensure that they are in line with Sharī'ah principles and the long-term financial sustainability of the Retakaful fund. This may involve diversifying the portfolio to reduce concentration risk, investing in more liquid and lower-risk assets, and seeking professional investment advice to improve returns.

### **Conclusion**

A solvency deficit occurs when a fund is in deficit if all claims needed to be paid out at that moment. The operator is expected to address the treatment of qard facility in the operation of a takāful fund, if the fund is unable to meet its obligations (because of a deficit or lack of liquidity), where such a loan will be repaid out of future underwriting surpluses. It is acceptable for the Takāful operator to offer qard out of the shareholders' fund (SHF) or acquire from a third party which is to be repaid out of future surpluses. This is to ensure that a Takāful undertaking (TU) would be able to meet all its contractual obligations and commitments, as well as to foster confidence amongst the general public, in particular takāful participants, in the financial stability of the Takāful sector, otherwise potential takāful participants may be disinclined to join a fund that carries a substantial debt to be repaid out of future surpluses that would otherwise be attributable to

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the takāful participants, as takāful is marketed on a basis of surplus distribution.

Without proper regulation of the industry, there is room for nepotism like behaviour, corruption, and non-transparent, inadequate, and inaccurate financial reporting, which may result with the financial collapse and bankruptcy of many companies and the reputation risk of takāful and the Islamic finance industry.

This paper provides useful insights to the supervisory authorities responsible for takāful industry in designing appropriate capital requirements regulations for the protection of takāful participants. Consequently, the understanding of those factors that threaten the solvency and underwriting capability of the takāful fund would help to strengthen measures required for the management of reserves and adequacy capital resources in takāful funds.

In such a situation, the TOs or RTOs may increase premiums or contribution rates, reduce expenses or utilize qarḍ facility to cover the deficit i.e., TOs or RTOs may provide qarḍ out of the shareholders' fund, or procure from a third party, which is to be repaid out of future surpluses. It is the TOs' fiduciary in managing the takāful funds, TOs are expected to set appropriate and adequate provisions for the takāful funds to meet future obligations (BNM, 2013). Otherwise, they reviewed their investment policies and asset allocation strategies to mitigate the impact of the losses.

Furthermore, the paper would assist the supervisors and takāful operators with regard to the selection of measurement and treatment of qarḍ, and application of IFRS 17 to takāful industry for those jurisdictions.

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