

3rd December 2012

Shariah Standard on Mudarabah

- 1.1. In an effort to standardize the implementation of sharia compliant 'contract types', Bank Negara Malaysia (BNM) recently introduced a Standard on the mudarabah contract (the Standard). The mudarabah contract is defined in the guidelines as a contract between a capital provider (*rabbul mal*) and an entrepreneur (*mudarib*) under which the *rabbul mal* provides capital to be managed by the *mudarib* and any profit generated from the capital is shared between the *rabbul mal* and *mudarib* according to a mutually agreed profit sharing ratio (PSR) whilst financial losses are borne by the *rabbul mal* provided that such losses are not due to the *mudarib*'s misconduct, negligence or breach of specified terms.
- 1.2. The Standard espouses two levels of compliance:
 - (i) guidance which all Islamic Financial Institutions (IFIs) are required to follow (referred to as a standard) and
 - (ii) guidance which expands on the practice of the contract which is not necessarily required to be followed (referred to as a practice guide).

As IFIs these standards and practice guides therefore apply to takaful operators.
- 1.3. The implementation date of this Standard is 1 January 2014. It is our understanding that these standards are not retro-active, i.e. it does not apply to takaful contracts initiated prior to the implementation date.

How do these Standards affect Takaful?

- 2.1. Takaful is bound by the laws of *Muamalat* (Sharia laws as it applies to the conduct of businesses). As such Sharia compliant contract types are in use in the business of takaful. The two commonly used contract types are the *Mudarabah* contract and the *Wakala* contract. In fact the first takaful company in Malaysia, Syarikat Takaful Malaysia, at its inception used the mudarabah contract as the sole contract between the takaful operator (Operator) and the takaful participant (Participant). The second takaful operator, Takaful Nasional, introduced a variation of the mudarabah contract (termed as *Modified Mudarabah*) as its major underlying contract type. Only when Takaful Ikhlas started its operation in 2002 did the wakala contract become popular as the contract between the Operator and the Participant for the underwriting of the business while the Mudarabah contract was used only to define the business of investing the funds of the Participants.

- 2.2. The introduction of this Standard will significantly affect those takaful companies still using the mudarabah contract as the basis of the business of takaful (in particular the underwriting business). To recap, the concept of profit in mudarabah was extended to the interpretation of surplus in takaful, notwithstanding that surplus is the excess of income (including contributions) over outgo (including claims) which is different from the usual accounting interpretation of profit which is the income/capital gains earned on the capital invested.

Example 2.2 (mudharabah takaful contract):

Contribution	1000
Claims	700
	<hr/>
Surplus / 'Profit'	300
	<hr/>

This mudarabah “profit” is then distributed to Participants and Operator based on the PSR.

- 2.3. As explained above, under the mudarabah contract as practiced by some takaful operators, surplus is equated to profit. This now has to change with the introduction of the Standard. The Standard defines Profit under the mudarabah contract as (in Paragraph 12.2):

“Profit is the value created over and above the mudarabah capital which is determined based on the profit determination method acceptable by market standard or practices”.

Example 2.3.1

Fund / Capital at start of year	1000
Fund at end of year	1300
	<hr/>
Profit	300
	<hr/>

It reinforces this definition of ‘Profit’ by defining ‘Loss’ as (in Paragraph 13.1):

“A loss is depletion of the value of capital”.

Example 2.3.2

Fund / Capital at start of year	1000
Fund at end of year	700
	<hr/>
Loss	300
	<hr/>

Clearly therefore, when contributions are used to pay claims there is a 'loss' if the contract is defined as a mudarabah contract (Example 2.2 above). The 300 Surplus in the Example should not therefore be distributed either to the Participant or to the Operator if the mudarabah contract is used. Currently this is not the case. **Thus, from 1 January 2014, the mudarabah contract can no longer be used in takaful for the purpose of underwriting risk.**

- 2.4. The Standard also affects Takaful in the way it determines the 'profit' on the investments of the Participant's funds. We examine how this Standard may affect the existing practice of Operators when managing Participant's investments under the following headings:

Guarantee of Capital

Paragraph 14.1 states that the *mudarib* shall not guarantee the capital and/or profit of the *rabbul mal*. This applies to the Participants Investment Funds (PIF) and the Standard therefore makes it clear that the PIF can have negative returns in any one year resulting in the PIF having a value less than the total capital invested.

Recognition of Profit

The Standard lays out clear guidelines as to how profit should be recognized under the mudarabah contract. We summarize these guidelines as follows (Paragraph 12.6):

- (a) On a realized basis (i.e. when assets such as equity investments are sold at a profit).
- (b) On a 'constructive' basis. We interpret this as a value based on an independent valuation, As for example, the value of a stock as quoted on Bursa Malaysia. It however qualifies this basis by stating that:
 - (i) A profit reserve may be created (as a practice guide)
 - (ii) A final consolidation and adjustment shall be undertaken at the end of a certain period or at the times of actual realization of profit to arrive at the actual amount of profit (as a standard)

It further states as a standard that unrealized gains recognized during the mudarabah tenure shall be recognized as profit and be included in the profit and loss calculation for the mudarabah (in Paragraph 12.18).

Distribution of Profit

The Standard (Paragraph 12.17) says that ‘Profit shall be distributed upon the maturity of the mudarabah or at an agreed period’.

The mudarabah contract type is typically used on a project basis where the tenure of the contract is relatively short. In Family takaful, the tenure of the contract is typically much longer, in some causes in excess of thirty years. So how would the Standard affect the accounting of the investments of the PIF for the purpose of surplus distribution? We highlight the issues through examples below:

Consider a single contribution Family takaful plan where the Participant’s ‘Capital’, (i.e. contribution) which is available for investing through a mudarabah PIF is RM1,000. The takaful contract is for a duration of ten years and profits are shared equally between the Participant and the Operator (PSR 50:50). The tables below show the distributed profits (assume paid out in cash i.e. not accumulated) should the investment profit and loss be distributed annually (Table 2.4.1), every five years (Table 2.4.2) and only at the end of the contract term i.e. ten years (Table 2.4.3):

Table 2.4.1 Distribute Profit/Loss every year

Year	Participant’s Capital at start	Rate of return (%p.a.)	Profit/loss	Distributed profits	
				Participants	Operator
1	1000	5.0	50.00	25.00	25.00
2	1000	6.0	60.00	30.00	30.00
3	1000	3.5	35.00	17.50	17.50
4	1000	6.0	60.00	30.00	30.00
5	1000	4.5	45.00	22.50	22.50
6	1000	3.5	35.00	17.50	17.50
7	1000	5.0	50.00	25.00	25.00
8	1000	2.0	20.00	10.00	10.00
9	1000	7.5	75.00	37.50	37.50
10	1000	5.0	50.00	25.00	25.00
11	1000			240.00	240.00

Table 2.4.2 Distribute Profit/Loss at end of every 5 years

Year	Participant’s Capital at start	Rate of return (%p.a.)	Profit/loss	Distributed profits	
				Participants	Operator
1	1000.00	5.0	50.00	0.00	0.00
2	1050.00	6.0	63.00	0.00	0.00
3	1113.00	3.5	38.96	0.00	0.00
4	1151.96	6.0	69.12	0.00	0.00
5	1221.07	4.5	54.95	138.01	138.01
6	1000.00	3.5	35.00	0.00	0.00
7	1035.00	5.0	51.75	0.00	0.00
8	1086.75	2.0	21.74	0.00	0.00
9	1108.49	7.5	83.14	0.00	0.00
10	1191.62	0.5	59.58	125.60	125.60
11	1000.00			263.61	263.61

Table 2.4.3 Distribute Profit/Loss at end of investment period

Year	Participant's Capital at start	Rate of return (%p.a.)	Profit/loss	Distributed profits	
				Participants	Operator
1	1000.00	5.0	50.00	0.00	0.00
2	1050.00	6.0	63.00	0.00	0.00
3	1113.00	3.5	38.96	0.00	0.00
4	1151.96	6.0	69.12	0.00	0.00
5	1221.07	4.5	54.95	0.00	0.00
6	1276.02	3.5	44.66	0.00	0.00
7	1320.68	5.0	66.03	0.00	0.00
8	1386.72	2.0	27.73	0.00	0.00
9	1414.45	7.5	106.08	0.00	0.00
10	1520.53	5.0	76.03	298.28	298.28
11	1000.00			298.28	298.28

As can be seen, when the investment return each year is positive, the total profits distributed to the Participants and the Operator under the three scenarios are the highest when profit is distributed at the end of ten years and the lowest when it is distributed annually. This is to be expected as we are considering total profits distributed without allowing for the time value of money of **when** the profits were distributed.

Now consider a fluctuating investment return (total of investment income, including realized and unrealized capital gains) with some years generating a negative return. Similarly we consider three scenarios, profit distributed annually (Table 2.4.4), every five years (Table 2.4.5) and only at the end of the contract term i.e. ten years (Table 2.4.6):

Table 2.4.4 Distribute Profit/Loss every year

Year	Participant's Capital at start	Rate of return (%p.a.)	Profit/loss	Distributed profits	
				Participants	Operator
1	1000	5.0	50.00	25.00	25.00
2	1000	10.0	100.00	50.00	50.00
3	1000	-5.0	-50.00	0.00	0.00
4	950	10.0	95.00	47.50	47.50
5	950	-10.0	-95.00	0.00	0.00
6	855	15.0	128.25	64.13	64.13
7	855	5.0	42.75	21.38	21.38
8	855	-5.0	-42.75	0.00	0.00
9	812.25	7.5	60.92	30.46	30.46
10	812.25	5.0	40.61	20.31	20.31
11	812.25			258.77	258.77

Table 2.4.5 Distribute Profit/Loss at end of every 5 years

Year	Participant's Capital at start	Rate of return (%p.a.)	Profit/loss	Distributed profits	
				Participants	Operator
1	1000.00	5.0	50.00	0.00	0.00
2	1050.00	10.0	105.00	0.00	0.00
3	1155.00	-5.0	-57.75	0.00	0.00
4	1097.25	10.0	109.73	0.00	0.00
5	1206.98	-10.0	-120.70	43.14	43.14
6	1000.00	15.0	150.00	0.00	0.00
7	1150.00	5.0	57.50	0.00	0.00
8	1207.50	-5.0	-60.38	0.00	0.00
9	1147.13	7.5	86.03	0.00	0.00
10	1233.16	5.0	61.66	147.41	147.41
11	1000.00			190.55	190.55

Table 2.4.6 Distribute Profit loss at end of investment period

Year	Participant's Capital at start	Rate of return (%p.a.)	Profit/loss	Distributed profits	
				Participants	Operator
1	1000.00	5.0	50.00	0.00	0.00
2	1050.00	10.0	105.00	0.00	0.00
3	1155.00	-5.0	-57.75	0.00	0.00
4	1097.25	10.0	109.73	0.00	0.00
5	1206.98	-10.0	-120.70	0.00	0.00
6	1086.28	15.0	162.94	0.00	0.00
7	1249.22	5.0	62.46	0.00	0.00
8	1311.68	-5.0	-65.58	0.00	0.00
9	1246.10	7.5	93.46	0.00	0.00
10	1339.55	5.0	66.98	203.27	203.27
11	1000.00			203.27	203.27

You can see that the results are very different as compared to the first set of examples. In fact, under the scenario where profit is distributed annually, the Participant's capital has been eroded from RM1,000 at the start to RM812 at the end of ten years. What has happened is that as the *rabbul mal* is solely responsible for losses, the losses in years 3, 5 and 8 (totalling RM187.75) has reduced the capital invested from RM1000 to RM812.25. This did not happen when profit/loss is distributed at longer durations (5 and 10 years in the examples) as the carried forward profit was sufficient to offset losses in any one year.

Paragraph 12.17 of the Standard explicitly says that profits shall be distributed upon maturity of the mudarabah or at an agreed period. On this basis, unless otherwise agreed between the Operator and the Participant, the mudarabah profit can only be distributed when the policy terminates. As it is unlikely that the existing takaful contracts clearly state when surplus would be computed, by default it would imply that only when the contract matures can profit be determined.

The Standard does allow the distribution of profits before the *mudarabah* term is completed. However, it establishes certain conditions should this be done. In particular, in Paragraph 12.16 it recommends the establishment of a profit reserve followed by a final consolidation and adjustment of this profit reserve to arrive at the actual amount of profit. This is reiterated in Paragraph 12.22 where a profit equalization reserve is suggested as a practice guide.

The Standard also recognizes instances where the *rabbul mal* capital may be depleted at the end of the contract period when in Paragraph 12.24 it mentions that the profit reserve of the *rabbul-mal* can be used to cover depletion of the *rabbul mal* capital. **We do not agree though that only the *rabbul mal* share of the reserve should be utilized as what can happen is that the *mudarib* receives a profit share when perhaps no profit has actually been earned on a cumulative basis over the contract term.** It would perhaps be fairer if the same proportionate share of profit reserve be used to cover the depletion of capital. Thus, in the example in Table 2.4.4, assuming the yearly distribution of profits go to a profit reserve instead of being paid out to the Operator and Participant annually, 36.3% of the *rabbul mal* and *mudarib* accumulated profit (RM258.77 each) would go to making good the depletion in capital (it is assumed in the example that the investment income earned on the profit reserve is distributed separately).

Capital remaining at the end of contract (ten years)	812.25
36.3% of <i>mudarib</i> profit reserve	93.88
36.3% of <i>rabbul-mal</i> profit reserve	93.88
Reconstituted Capital	1,000.00

What happens in the example above is that some of the profit that was distributed before is redistributed back to the Participant, as it has transpired at the end of the term of the contract that too much profit has actually been distributed. The Participant and the Operator in the example still receive 50% each of the total remaining profit earned over the term of the contract in accordance with the PSR agreed under the *mudarabah* contract (in this example RM164.84 [258.77-93.88] each).

What should the Operator do now?

- 3.1. If the Operator currently uses a mudarabah contract for the underwriting business then it should prepare for a switch to the wakala contract by 1 January 2014. This requires the setup of a new takaful risk fund, separate from the existing mudarabah risk fund. The existing mudarabah contracts would be allowed to run-off. Such a run-off requires careful consideration from an equity and practical perspective as to, for example, when and how should “profit” be distributed.
- 3.2. For those running the PIF on a mudarabah basis, it is worth considering switching (for new policies) to a unit-linked approach under a wakala contract and with the wakala fee determined as a percentage of the fund under investment. This would simplify the determination of the Operator’s income. For the existing book of PIF on the mudarabah basis, there is a need to consider carefully how profit and loss should be accounted for and whether a profit equalization reserve should be created.
- 3.3. This Standard should also give rise to questions as to how underwriting profit and loss should be determined other than under a mudarabah contract. The industry practice is to determine profit and loss in takaful on a yearly basis (though a monthly basis for determining profit and loss is not unknown) and at the very least this Standard will give pause to the need of a profit equalization reserve where the underlying takaful contract extends for a period greater than how profit/surplus is determined. In short, distributing profit on a basis shorter than the underlying policy duration requires some further thought. The profit equalization reserve will allow for greater equity to Participants.
- 3.4. We welcome this Standard as it provides clarity as to the definition of the Mudarabah contract irrespective of where it is used.