

# [Risk enable companies to be aware of](https://assignbuster.com/risk-enable-companies-to-be-aware-of/)

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Risk management canbe defined as a systematic approach to managing risks that threaten the assetsand income of a business or entrepreneurship. There are five types of risks in business have beenidentified that are relevant to takafulas follows: 1.    Underwriting risk2.

Operational risks3.    Credit risk4.    Liquidity risk5.    Market risk Underwriting risk andoperational risk are directly related to the operations of the takaful company. Whereas, credit risk, liquidity risk and market risk are associated with thecompany’s investment activities. All types of risk in takaful require specificrisk management strategies and need to be managed individually.

The effectively manage the risks intakaful include the following steps: 1.    Identifyingrisks2.    Managingrisks3.

Enhancingrisks management culture in takaful industry The three current practical challengesin risk management which is confronting takaful operators as follows: 1.              Shari’ah Based Challenges Practically, most of the risk management techniquesare not applicable to Islamic financial institutions due to Shariah compliancerequirements. Therefore, Shari’ah-based challenge to risk management wascreated for takaful companies. These challenges arise because Shari’ahprohibits the use of certain instruments such as derivatives involving futures, options, swaps; and debt sales. But these mentioned instruments are beneficialin conventional risk management. 2.              Internal ControlsInternal controls areimportant to recognize and assess the risks faced by takaful companies. Effectiveinternal control plays a crucial role in risk management of takaful companieswhich can evade takaful companies from systemic crises and enable companies tobe aware of the possible problems and risks they may face in the future.

Tohave an effective internal control mechanism, the takaful company must ensurethat Shariah controls are in addition to all statutory regulations. It urgesSyariah audit requirements as part of an on-going system of internal control.  3.       Corporate GovernanceIt is crucial for takafulcompany to have an effective corporate governance to ensure the independenceand efficiency of board of director and management level who take theresponsibility to develop policies and implement strategies for risk managment. The lack of effective corporate governance may caused BOD not functioningindependently and thereby poses a challenge to risk management. If theineffective corporate governance phenomenon persist, it will increase theoperating risks which may lead to operational failure. This operational failureis due to the inability of BOD to implement independent and unbiased decisionsfor the best interests of all stakeholders.

As a shari’ah compliance insurancecompany, takaful companies are facing with additional challenge related to theShari’ah Supervidory Board’s corporate governance. This additional challengehighlight more need to incorporate corparate governance culture to resolveissues related to the takaful industry. In takaful, the surplus is definedas an asset minus the liability of takaful risk fund. Surplus exists due to thedifference between actual experience and price assumptions. Total of surplusdepends on how assets and liabilities of the takaful fund are assessed. Surpluscan be split among participants (policyholders), to takaful operators(shareholders), and keep in the fund for contingencies. The surplus of the tabarru’account to be distributed between participants and takaful operators is basedon the fact that takaful contracts are generally built on tabarru’ (donation)and ta’awun (help-assist) along with mutual consent between parties.

Tabarru isa key principle that underlies takaful products. Other shari’ah principles suchas mudarabah are wakalah are used to support the implementation of takafuloperations. Surplus comes from many sources suchas excessive investment income, favourable experience in benefits such asmortality benefits, fire etc. However, in family takaful, the surplus isusually treated separately, namely underwriting surplus. This is due to thatthere are often separate models used for investment, such as mudarabah while underwritingsurplus aspects are more likely to be considered under the wakala model. From Shari’ah perspective ofsurplus, underwriting surplus arise from risk funds which are actually anexcess of takaful contributions derived from claims incurred regardless of anyinvestment gains arising from the contributions accumulated in the fund. Therefore, the operator does not contribute to any incremental growth orincrease in the value of the funds. The Accounting and AuditingOrganization for Islamic Financial Institutions (AAOIFI) is an well-known Islamicinternational autonomous non-for-profit corporate body that prepare and providestandards for Islamic financial institutions and the industry, includingtakaful.

According to AAOIFI, there are relevant standards allocating for thesurplus, namely Financial Accounting Standards (FAS) No. 13 (Disclosure ofBases for Determining and Allocating Surplus or Deficit in Islamic InsuranceCompanies). FAS 13 is intentionally incorporated to determine and allocatesurplus or deficit in Islamic Insurance Companies. It is required in thestandards for takaful operators to provide a statement of surplus (or deficit)of the policyholder. The takaful operators themselves should disclose themethod they use in allocating underwriting surplus and the shari’ah basisapplied in the notes. For general takaful funds, theunderwriting surplus is determined for each takaful business class after takinginto account commissions, unearned contributions, retakaful, claiming incurredand management expenses. Surplus can be distributed according to the terms andconditions set by the company’s shari’ah committees and all takaful operatorshave to disclose the amount of surplus in their takaful fund.

For family takaful, the surplus isdetermined by the annual actuarial valuation of the family takaful fund. Thesurplus that can be distributed to the participants is determined afterdeducting the claims or benefits paid, retakaful provisions, commissions, managementexpenses and reserves. It is distributed according to the terms and conditionsset by the company’s Shari’ah committees. Takaful company may invest the insurancesurplus for the policyholder’s account, if there is a real provision for thiseffect in the insurance policy.

The consideration to be paid to the party insuch investment related with percentage of investment profit in mudarabah orcommission amount in the case of the agency, shall be stated in the insurancepolicy.