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Takaful through the Eyes of an Investor - Opportunities and Challenges

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   - Different Takaful Models Around the World
   - Takaful Market
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3. Challenges and Opportunities as a Business Investment
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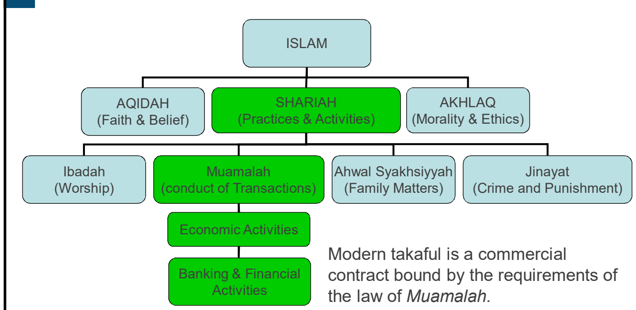
1. Introduction to Takaful

What is Takaful?

How Takaful Begun?

Takaful started in the late 1970's in Sudan followed by several other countries such as Saudi Arabia, UAE and Malaysia. The driving force was the *fatwa* by the Organisation of Islamic Cooperation (OIC) which declared conventional insurance *haram* (i.e. non-permissible).

The various branches of Islamic teachings



Modern takaful is a commercial contract bound by the requirements of the law of *Muamalah.*

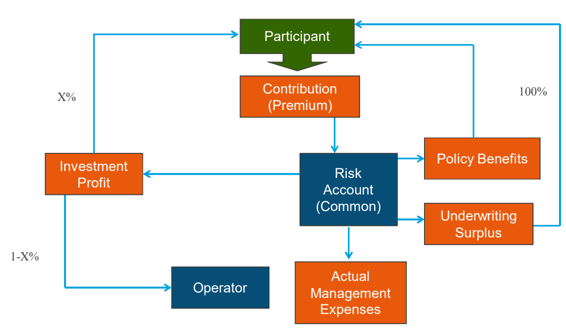
Guidance is provided by religious scholars by means of *fatwas.*

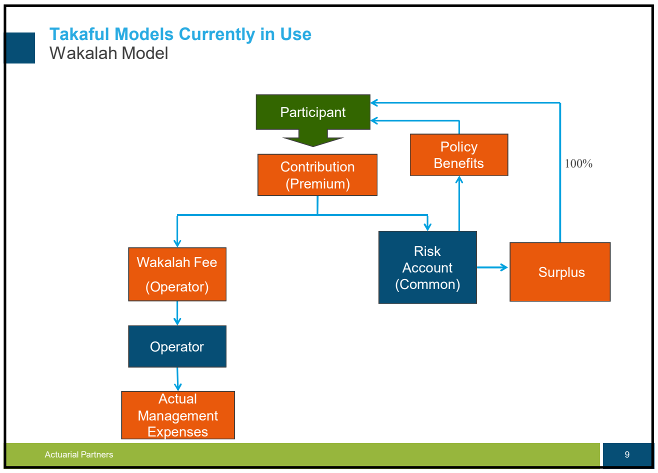
Fundamental Concepts of Takaful

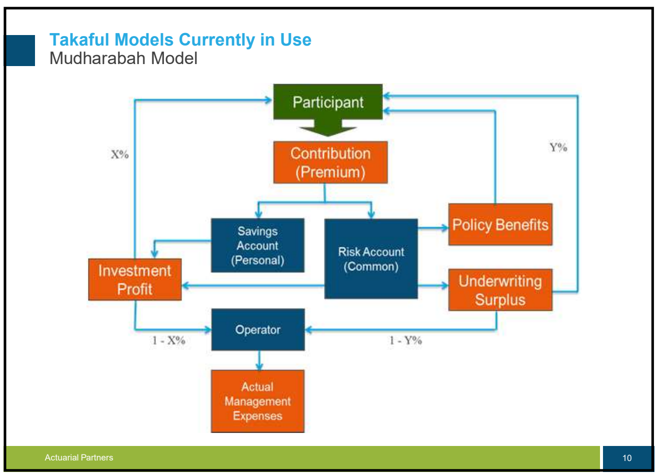
- **Takaful is about risk sharing** (similar to a cooperative or a mutual insurer) rather than risk transfer (the business model for a stock insurance company).
- Under a risk-sharing model, the intention is for all participants to **help each other** should the “insured” event occur.
  - The pool where all the participants’ contributions are accumulated is used to compensate for the financial loss.
  - Should there be a surplus or a deficit in the pool, this is for the account of the participants.
- The takaful company or operator acts as a ‘**fund manager**’ for the participants. They do not take in any takaful / insurance risk. They are compensated by the participants via a fee.
- **The investments of the takaful fund are Shariah-compliant**. This means *riba’*-based investments and investments in companies involved in non-Shariah-compliant activities are not allowed.

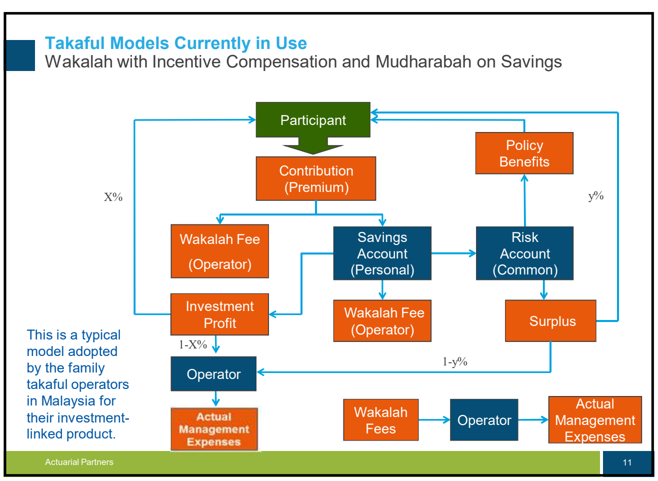
Different Takaful Models Around the World

Takaful Models Currently in Use
Sudan Model



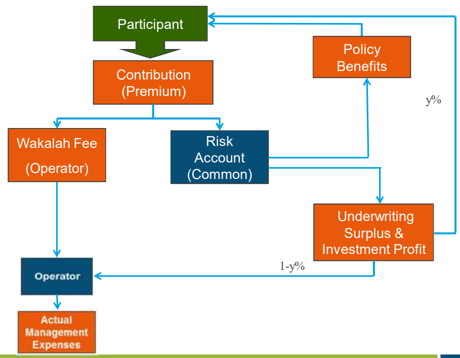

Takaful Models Currently in Use
Wakalah Model
Participant
Contribution (Premium)
Policy Benefits
100%
Wakalah Fee (Operator)
Risk Account (Common)
Surplus
Operator
Actual Management Expenses
Actuarial Partners
9


Takaful Models Currently in Use
Mudharabah Model
Participant
X%
Contribution (Premium)
Y%
Savings Account (Personal)
Risk Account (Common)
Policy Benefits
Investment Profit
Underwriting Surplus
1 - X%
Operator
1 - Y%
Actual Management Expenses
Actuarial Partners
10


Takaful Models Currently in Use
Wakalah with Incentive Compensation and Mudharabah on Savings
Participant
Policy Benefits
Contribution (Premium)
X%
y%
Wakalah Fee (Operator)
Savings Account (Personal)
Risk Account (Common)
Investment Profit
Wakalah Fee (Operator)
Surplus
This is a typical model adopted by the family takaful operators in Malaysia for their investment-linked product.
1-X%
1-y%
Operator
Actual Management Expenses
Wakalah Fees
Operator
Actual Management Expenses
Actuarial Partners
11

Takaful Models Currently in Use
Wakalah with Surplus Sharing

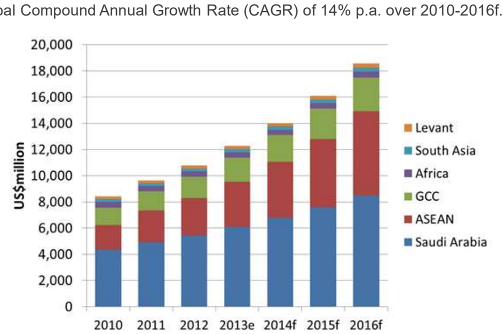
This is a typical model adopted by the takaful operators in Malaysia for their general takaful business. Note that BNM restricts the surplus sharing to the operator where *y%* cannot be lower than 50%.



Takaful Market

Growth in Global Takaful Market (US$m)

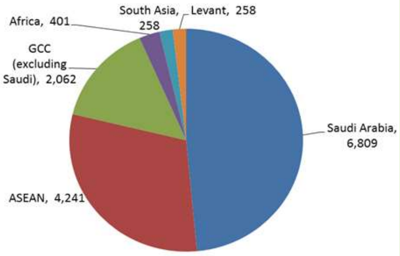
Global Compound Annual Growth Rate (CAGR) of 14% p.a. over 2010-2016f.



Note: Saudi Arabia has a cooperative market.
Source: Estimated in Global Takaful Insights 2014 by Ernst & Young

Global Takaful Market in 2014 (US$m)

The global gross takaful contributions is estimated to be US$14 billion in 2014f (US$12.3 billion in 2013).



In GCC, Saudi accounts nearly 80% of the market, followed by UAE at 15%.

In ASEAN, over 70% of total gross contributions are from Malaysia.

Malaysia has the largest family takaful market globally.

Most of the other markets are focused towards general takaful business.

Source: Estimated in Global Takaful Insights 2014 by Ernst & Young

Overview of Takaful Regulations in Malaysia

Key Developments

June 2008:
Guidelines on Outsourcing for Takaful Operators
- Outlines minimum outsourcing requirements to be followed by Takaful Operators

Jan 2011:
Shariah Governance Framework for Islamic Financial Institutions
- Sets out responsibilities and duties of the Board, Shariah Committee and management

Jan 2012:
Guidelines on Takaful Operational Framework (TOF)
- Sets out the standard for Takaful Operators

June 2013:
Islamic Financial Services Act 2013 (IFSA 2013)
- Increased onus on Board of Directors
- Need to set up holding company

Jan 2014:
(RBCT)
- Stringent capital requirements

April 2016:
ICAAP for Takaful
- Aimed at ensuring a licenced person has adequate capital to meet its capital requirements on an on-going basis

June 2016:
Phased Liberalisation of Motor and Fire Tariffs
- Likely to affect underlying profitability of these classes through re-rating and stiff competition

June 2019:
Revised TOF
- Aimed at further clarifying the operationalisation of Shariah contracts
- Seek to spur greater innovation in takaful while further safeguarding the position of takaful participants

2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019

2. Takaful vs. Insurance and Mutual

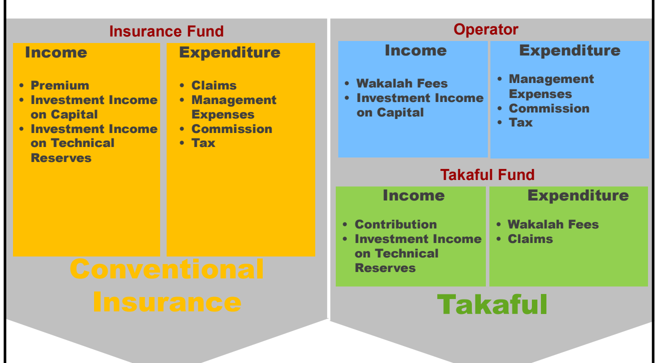
Takaful vs. Insurance

	Conventional Insurance	Takaful
Organization Principle	Profit for shareholders	Mutual for participants
Risk Ownership	Risk transfer from policyholders to insurer	Cooperative risk sharing between all participants, while operator only manages the pool without taking on 'insurance' risk
Value Proposition	Profit maximization	Welfare and spiritual satisfaction
Laws	Secular regulations	Shariah regulations
Form of Contract	Contract of sale	Islamic contracts e.g. Wakalah / Mudharabah
Uncertainty	Sum assured only payable on occurrence of risk events which may or may not occur → payment is uncertain	The donation concept of tabarru' overcomes the issue of uncertainty, as it becomes a gratuitous contract
Gambling	Insurer takes speculative risk with its capital. Makes a profit/loss based on its underwriting results	Concept of tabarru' / donation making the contract unilateral
Investments	No prohibition on the asset classes of investment e.g. stocks in gambling, brewery or highly leveraged companies	Investments limited to Shariah-compliant assets i.e. sukuk, Shariah-approved stocks
Profit/Surplus	Non-participating products: Surplus belongs to shareholders Participating products: Surplus is shared between the policyholders and shareholders	Wakalah model: Surplus belongs to participants Mudharabah model: Surplus is shared between the participants and operator, based on the pre-agreed arrangement

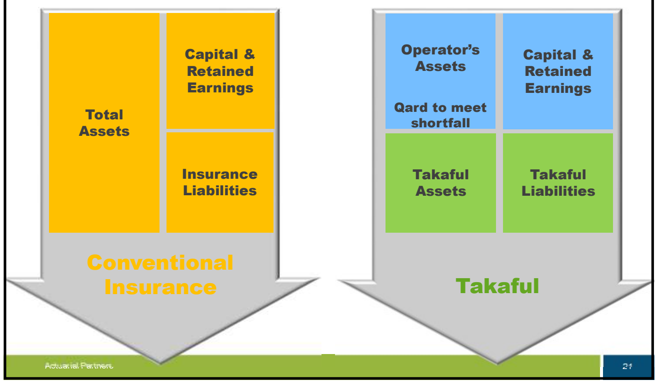
Takaful vs. Mutual

- Takaful is essentially based on **mutual cooperation** between members. Thus takaful and mutual operate in a very much alike model.
- The main difference is that under mutual, the members are responsible to **make good of the deficits**, while in takaful, the operator will provide a **benevolent loan** (or Qard Hassan) to cover for those deficits. Qard Hassan will be repaid from future surplus.
- The other difference is that for mutual, the **capital** comes from the members, while in takaful, the takaful operator provides the capital.
- In a mutual set-up, they would also have a **representative** from the members in the Board of Directors, while that is normally not the case in takaful.

Revenue Account
Comparison between Insurance and Takaful (Wakalah Model)



Balance Sheet
Comparison between Insurance and Takaful (Wakalah Model)



Takaful vs. Insurance
Qard Hassan

- As Takaful works on a risk sharing concept, any deficit incurred in the Risk Fund 'belongs' to the participants, not the takaful operator.
- However, instead of recouping these losses from the participants, the takaful operator would provide a **benevolent loan** / non-interest loan known as Qard Hassan to the Risk Fund.
- The Qard Hassan will then be re-paid from the **future surplus** of the Risk Fund.
- Note that the Qard Hassan must be fully repaid first before any surplus from the Risk Fund can be distributed.

3. Challenges and Opportunities as a Business Investment

Three Revenue Streams to Make Money from Takaful (Modified Wakalah Model)

1) Surplus Sharing

- Any surplus from the Participants' Fund is split between the Participants and Takaful Operator (TO) at a pre-agreed percentage
- Some regulations may put a limit on the amount that the TO can take
- Some jurisdictions do not allow the sharing of surplus with the TO under a Wakalah model

2) Wakalah Fee

- Participants pay a pre-agreed fee (*Wakalah)* to the TO for managing the Participants Fund
- TO retains the difference between the fees collected and actual operating expenses – hence, the need for efficiency in managing expenses
- Wakalah fee may also be loaded for 'profit'

3) Investment Income

- TO invests their capital in shariah-compliant instruments and keeps all investment income
- Investment income in the Participants' Fund is normally shared with the TO

Takaful Capital and Financial Implications

Area	Conventional	Takaful
Minimum Capital Requirements	Paid-up capital requirement is normally the same for both	
Risk-Based Capital	Subject to Risk-Based Capital (RBC) regime which is normally the same for both	
Financials	Under IFRS4, fund reporting is being practiced. Under the impending IFRS17, debates are still on-going on the application of IFRS17 to takaful (e.g. on fund reporting, cohorts and cross-subsidization, surplus sharing)	

***Qard Hassan* (Benevolent Loan)**

- Any deficit in the Participants' Fund 'belongs' to the Participants, not the TO
- However, instead of recouping these losses, the TO is required to provide a benevolent (interest-free) loan known as *Qard Hassan* to the Participants' Fund
  - This results in a **de facto financial guarantee** from the TO
- The *Qard Hassan* must be fully repaid first before any future surplus can be distributed

Challenges in Takaful as a Business Investment

Challenges in Takaful as a Business Investment

- Market perception on takaful being the same as insurance, except it is halal.
- Market perception on takaful being cheaper than insurance.
- Non-level playing field between takaful and insurance i.e. particularly when identical regulations are applied across both business models despite intrinsic differences in respective operating models and corresponding risks. E.g.: capital requirement i.e. the same risk charges are imposed for both insurance and takaful despite different risk profile; stiff competition with conventional insurance when they are clearly of two different natures.
- Limited retakaful capacity due to systemic challenges – so limits the breadth of underwriting capacity for takaful operators.
- Restrictions on investment – limited shariah-compliant assets and lower returns on shariah-compliant assets.

Challenges in Takaful as a Business Investment

- Limited talent and resources.
- The need for a capable systems to determine and allocate the surplus distribution to each individual participant.
- Higher expenses cost from maintaining a shariah department and board as well as systems for surplus sharing.
- Uncertainties faced by takaful under IFRS17 reporting.
- With risk-sharing concept in takaful, expected ROE for takaful should (by right) be lower than insurance given the lower expected risk. However, this is not necessarily acceptable from the Board of Directors' perspective especially when the same holding group has stakes in conventional insurance company and takaful company.

Opportunities in Takaful as a Business Investment

Opportunities in Takaful as a Business Investment

- Growth prospects for takaful:
  - low penetration rate to-date
  - the rise of the young and affluent Muslim population
  - the growth of Islamic finance
- Increasing demands for takaful in line with increasing awareness on takaful and reducing misconception on takaful being for Muslims only.
- Continuous development of takaful products – through learning from the experience of the conventional insurance, yet based on the concepts of mutuality and risk sharing.
- Expanding distribution channels – e.g. imams and religious leaders conduct talks and gatherings to promote the importance and benefits of takaful products in Indonesia.

Key Considerations as an Investor in Takaful

Key Considerations as an Investor in Takaful

- **Know** the market and its regulatory environment.
- **Market positioning** with an existing conventional license.
- **Takaful model** that fits the company's strategy and acceptable by the local shariah scholars.
- **Resources** from key personnel with takaful background to Board Shariah to systems.
- Shareholders need to reassess the expected **ROE** for takaful based on its perception of risk that it carries. If the expected risk is lower (given the risk sharing concept), then the expected ROE can be lower.

4. Roles of an Actuary within Takaful

Actuary Roles in Takaful

- More than we think! Especially given the infancy of takaful relative to insurance.
- Outside the actuarial horizons (i.e. reserving, pricing, capital modelling), our **quantitative technical skills and input** would come in handy in other **non-actuarial departments** too; e.g. finance, risk management, asset-liability management, retakaful, underwriting, strategic planning, and even claims.
- This is because we have the sound understanding of the working model of the business, the cash flows revolving the takaful model, and of course the risks surrounding the business – hence, enabling us to contribute to these functions.
- An actuary could be **juggling between various roles** in a new / small takaful company given his/her analytical skills. The downside of this is that there could be a potential conflict of interest.

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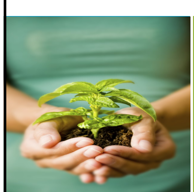

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