

London Takaful Summit 2008

**Islamic Asset Management Role in Enhancing Takaful
Provider's Asset**

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Contents

Section 1	Macro Analysis
Section 2	Micro Analysis
Section 3	Issues
Section 4	External Asset Manager: True Partner to Takaful Provider

SECTION 1

Macro Analysis

- Takaful is not just insurance with Islamic underlying
- Global trend in Takaful

Islamic Insurance or Takaful?

Insurance (Risk Transfer)

+

Islamic Investment

~~TAKAFUL?~~

Not!

Tabarru' (Risk Sharing)

+

Islamic Investment

TAKAFUL?

Yes!

Implications to Islamic Asset Management?

- Asset Management must go beyond ALM (beyond immunization)
Knowledge on Takaful structure is vital (adaptation)
e.g. Alignment between asset managers' incentive vs takaful structure (adaptation)

Global Trend in Takaful

1. Global Takaful is showing respectable growth, but still at a fraction of conventional insurance

	2007	2015 (forecasted)
Global Takaful Premium	\$3b	\$15b
Conventional Insurance	\$3,700b	N/a
Takaful/Conventional	< 0.1%	<0.5% (even if assume conventional growth stagnant)

2. Takaful General/Life ratio is converging towards conventional ratio

	2007		2015	
	Islamic	Conventional	Islamic	Conventional
General	80%	53%	52%	n/a
Life (Family)	20%	47%	48%	n/a

Implications to Islamic Asset Management?

- Need more long term sukuk (especially the active ones)
- Malaysia has good diversity of long term sukuk across credit, sectors & structures
- For asset managers, it's not just availability of assets (especially sukuk), but expertise & adaptability in managing takaful assets matter, even in the absence of active market.

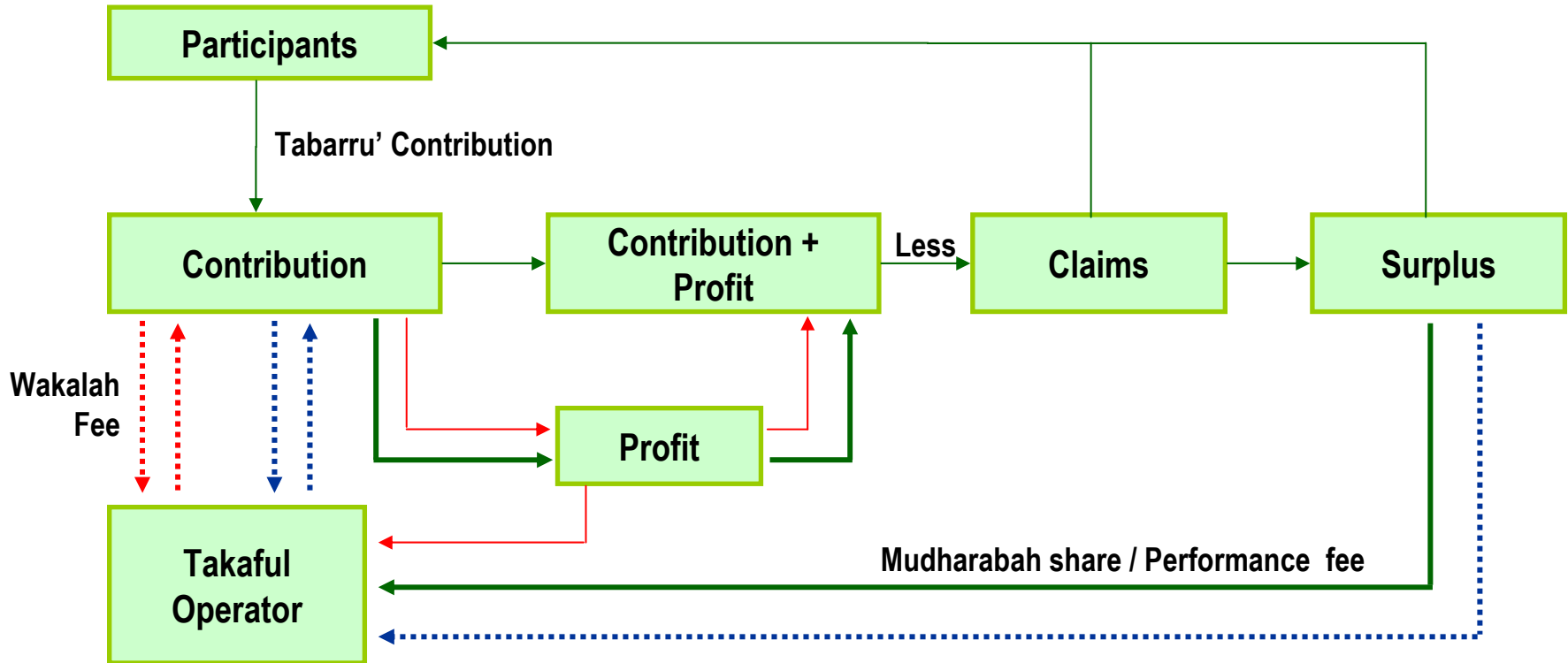
SECTION 2

Micro Analysis

- General understanding of various Takaful structures
- Islamic asset managers adaptability to the different Takaful structures

Various Takaful Structures

Adaptation by asset managers is dependent on different form of fee/profit/surplus flows



Basic Mudharabah ————
Modified Mudharabah —————

Basic Wakalah
Modified Wakalah

Adaptation to Different Takaful Structures

Asset manager's motivation can be closely aligned to different Takaful structures

Risk tolerant	Takaful Structure	Asset manager (AM)'s position	Potential arrangement between Takaful & AM
Likely to be risk takers	Basic Mudharabah	Share profit before claim (gross)	Performance based fee with market driven benchmarks
	Modified Mudharabah	Share profit after claim (net)	Performance based fee with benchmarks likely tied to potential claims level
Likely to be risk averse	Basic Wakalah	Usually receive fixed mgt fee	Fixed mgt fee consistent with the fixed wakalah fee received by Takaful operator
	Modified Wakalah	May receive both fixed mgt fee & performance fee	Fixed mgt fee + performance fee based on potential claims level (or market driven)

SECTION 3

Issues

- Regulatory issues
- Risk management issues
- Emerging markets issues

Regulatory issues

#1: Asset Manager vs Treasury

Asset manager's product = investment product

Treasury product = deposit product

From some regulatory (prudential) standpoint, deposit is "safer" & hence attracts lower capital charge. Takaful prefers Treasury products then, even though the profile is the same.

#2. "Prudent Man Rule" vs "Prudent Investment Rule"

Many regulatory restrictions on insurance (inclusive of Takaful) is based on "Prudent Man Rule" where the guidelines are very prescriptive (eg x% in govt bonds, y% in equities etc).

Modern portfolio theory advocates "Prudent Investment Rule" where the risk position is measured at portfolio level, not individual asset class. This is a better approach as asset managers will be accorded more flexibility in optimizing the portfolio's risk adjusted return. Afterall, asset managers are the expert in portfolio diversification on different asset classes.

More so for Takaful's portfolio as the essence of Takaful structure is **Risk Sharing**.

Risk Management Issues

#1: Hedging Mechanism

Hedging is good to protect portfolio's value, but should not be done at any cost!

Takaful operator should assess the expected net yield of the hedged portfolio; is it still higher than risk-free rate + desired premium? If much less, then an active risk management is warranted (eg active currency overlay). Asset managers should be able to advise on the proper strategy (if they're appointed, of course!).

Some portfolio is required by regulator to maintain some percentage of portfolio to be fully hedged. If this is the case, active risk management may be limited.

#2. Islamic Hedge Tools

Islamic hedging instruments are showing respectable growth, but still lack the necessary depth and breadth. It is only natural as the basic underlying instruments themselves are still lacking depth & breadth. The key issue is then on pricing, ie they're most likely to be less competitive than the conventional ones.

However, asset managers can team up with their counterparty at the treasury level for instance (if they're part of bigger group, that is) to find out the best possible structure of hedging to optimize the portfolio's net yield.

Emerging Markets Issues

#1: Good return but...

The recent hike in oil price prompt many asset managers' including takaful operators, to search for more investment opportunities beyond the traditional markets. Most go to emerging markets for the good potential returns they offer.

It is a respectable decision as it will diversify the portfolio. However, we should be mindful the risk profile may not match takaful's liability profile, hence ALM efforts especially will be hindered. Emerging markets security are usually high risk due to lack of financial infrastructure, low liquidity and lack of transparency.

However a small tolerable portion that would not affect the overall risk position should be allowed in order to enhance return.

#2. Optimization can be hindered as well

Some emerging markets have funny correlations among asset classes. Bonds positively correlated with equities at certain times, making it difficult to do tactical asset allocation.

But then again, even in the developed market, some anomalies are shown after the historic low level of interest (inverted yield curve), US triple deficit, subprime crisis etc. Bill Gross of PIMCO once said, "No firm or economist totally understands this financial interplay of the early 21st century"

Correlation studies do help in optimizing takaful return, especially when the Islamic instruments are still lacking the necessary depth & breadth. But it must be done with caution & good reasoning.

SECTION 4

External Asset Manager: True Partner to Takaful Provider

External Asset Manager, True Partner to Takaful Provider

We, external asset managers, especially the Islamic asset managers, truly believe we can be a good partner to any Takaful provider.

- #1. By appointing us, Takaful provider can focus in what they do best, ie providing Takaful services. As this market is still nascent, close relationship between us can only develop the overall Islamic capital market further. As discussed in the issues above, let us the asset managers assist you, the Takaful provider, in overcoming the challenges in the Islamic capital market.
- #2. Our main job is provide the most optimal portfolio to our clients, based on their investment needs. To satisfy Takaful clients, we must understand their structure. In addition to that, an asset manager with a diversified asset class expertise can even be in a better position to serve a Takaful provider, especially in this growing market where good Islamic instruments are still lagging behind the conventional.
- #3. Good asset managers should also be involved in the industry initiatives together with regulators, professional fraternities & even the community. By close engagements, we can find industry solutions together, especially when the challenges for this nascent market is much greater now (but nonetheless manageable, Insyallah).

Let's us work together in developing this Islamic capital market, locally & globally.

THANK YOU

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