

Takaful beyond the tipping point: The industry's dilemma in moving forward

Ajmal Bhatti, 1 July 2009

There was a time when some of us who have been associated with Islamic Finance and Takaful since the early 1990's were practically in the wilderness when it came to speaking in conferences on Islamic Banking or Insurance.

Our Islamic Banking colleagues at that time were too busy in developing their own products and services and takaful was simply an area of little impact or consequence to their top and bottom lines. The fact that Takaful was supposed to make their offering holistically compliant was far from their minds.

And our conventional insurance colleagues simply laughed at it. Takaful is a gimmick, they would say, that there was no difference between insurance and takaful and all this talk about Lack of Transparency, Semblance to Gambling and Riba was a window dressing. This was not just because of lack of understanding on their part but also because of how some of us were wrongly representing takaful industry. Very few of the people working in takaful companies had reasonable understanding of what it meant to be Shariah Compliant. They had found a job in a company that was selling insurance based on certain rules. They were least bothered to fully appreciate these rules. They knew conventional policy conditions. These were good enough to be used by re-labeling them takaful. Where would they find Islamic funds that would provide fixed return similar to returns on conventional stocks? Without knocking hard enough at the doors of Islamic Banks, without lobbying for more Shariah compliant funds, they would simply place funds on conventional deposits.

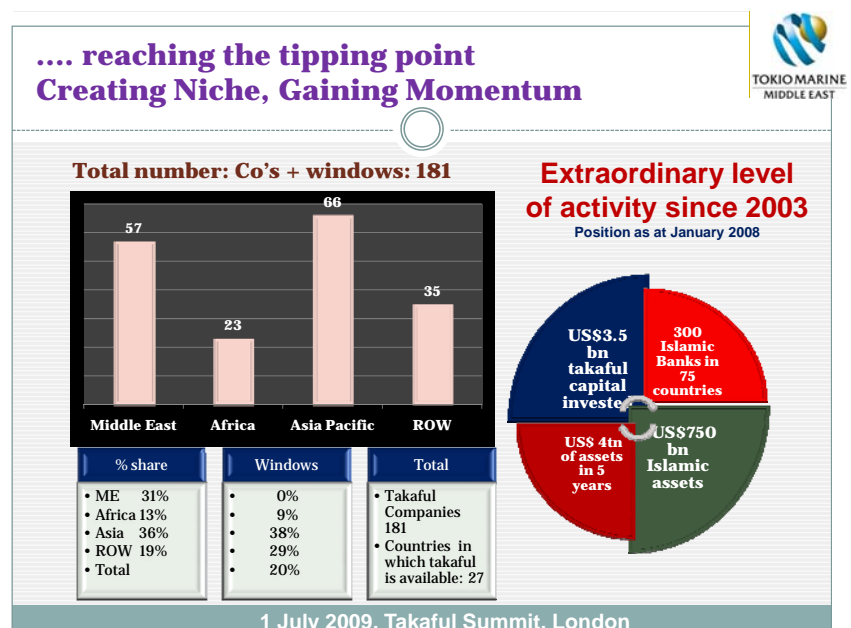


I recall once a skeptic of Islamic Finance, who made a claim in 1999 privately that Islamic Finance was doomed to fail within the next 5 years. As fate would have it, this Executive was given a prime management position in Islamic Finance and went on to lead and succeed an Islamic financial institution that has had numerous success stories. What my friend thought of the period of 5 years for the system to fail in fact turned out to be the period in which Islamic Finance and Takaful grew and strengthened. The resilience of the system lies in its goodness, in its ethics of balance of risk and reward through dealings in real assets. Such is its nature that makes it to withstand the kind of financial tsunamis that have played havoc in the conventional financial system.

Up until year 2000, the takaful industry's development was patchy and pedestrian, having gone through the pioneering years of late 1970's and 1980's of setting it up and getting it to crawl. The development in these years was driven by the entrepreneurial spirit of few who had the means and the will to succeed in bringing Shariah's application into the financial and commercial dealings for Muslims. For a good part of 20 years in the 1980's and 1990's, when Islamic Banking was getting stronger and stronger, takaful industry debated and dwelled upon ways to succeed helped by the governments of Bahrain and Malaysia. And then it happened. The tipping point came in 2003.

The global takaful industry took off, many markets experienced the introduction of takaful for the first time and many more markets saw not two, not three, but several takaful companies getting established.

What do we see at the tipping point? The view is one of resilience of Islamic finance and takaful. This has been amply demonstrated in

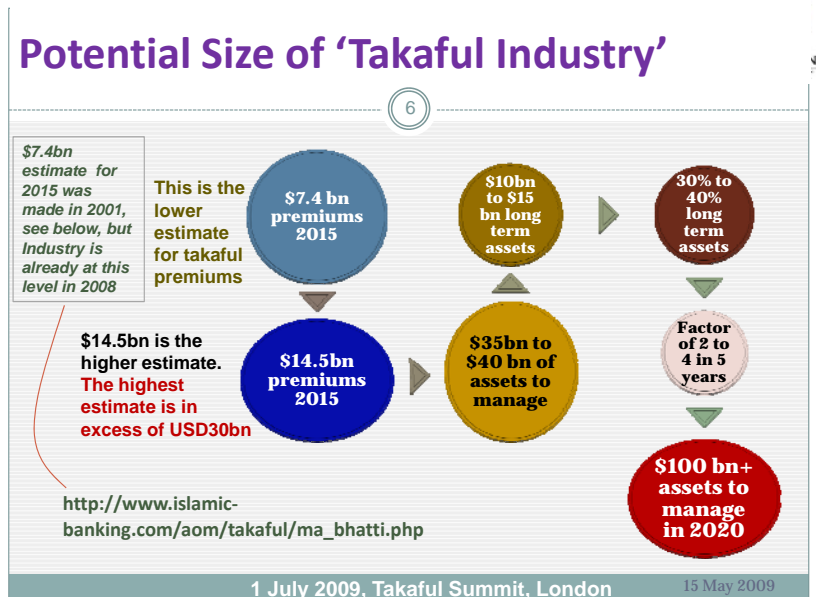


2008/09 within the backdrop of recent global economic crisis. Islamic Finance got impacted only to the extent of direct investments in companies and businesses affected by the economic crisis. But there were no derivatives and no credit default swaps and the like to shake it and sink it, like they did the conventional system to considerable extent.

At the tipping point, we find still the impetus and thrust of huge potential of uninsured assets and lives in areas of general and family takaful, huge capacity gaps that need to be filled for insuring mega risks and micro risks, and huge amounts of liquidity in Islamic Finance looking for ethical avenues of investment that has caused a scramble amongst world financial centers to be on that 'train' to becoming Islamic financial hubs.

The overall size of takaful is still small but growing and growing fast. The market share of takaful in countries where it is active ranges from 5% to 30%. Various estimates exist about the projected size of takaful industry: US\$7.4 billion by 2015? US\$14.5 billion or even higher US\$30 billion? Back in 2001, I was actively engaged in research work on Takaful and had estimated takaful to reach US\$7.4 billion by 2008 (http://www.islamic-banking.com/aom/takaful/ma_bhatti.php). Again, no one for sure knows the exact size of takaful in 2008, but later in this presentation I have some numbers on current size, and one of them is US\$6.5 billion in 2007. By that reckoning we must be very close to US\$7.4 billion in 2008.

If US\$14.5 billion were to be achieved by 2015, it can translate into US\$35 billion to US\$40 billion of takaful assets to manage by 2015, and over US\$100 billion by 2020.



The potential for takaful industry can indeed be much more than US\$14.5 billion or even US\$30 billion by 2015 if it can be steered in the right direction. For that, in my view we need a thorough self assessment. Here are few of the ideas for self assessment.

1. We still have difficulty in defining ourselves as an industry? We cannot even put an exact number on how big we are.
2. We seem to have developed a mind set of being a niche. Do we want to always remain a NICHE? If not, what are we doing about it?
3. Many takaful providers think takaful is good for only small risks and not for corporate and bigger risks. Why do we think that we cannot be big ticket players?
4. Are we doing enough to ensure that Takaful Ethics are not diluted? These ethics, the management of money and of funds in ways that are good for society and environment are the very basis of existence of Islamic finance and takaful. Therefore the question is, is mere screening at the selection stage of the assets to invest in and subsequent paper audit for Shariah compliance enough or should we be concerned about the actual activities of these asset types, businesses and industries in which funds of Islamic Finance flow into? Should we not be more concerned about whether or not these activities are fully aligned with socially and environmentally correct ways?
5. Do the masses know what is takaful? We need to spread awareness about takaful Correctly and Effectively

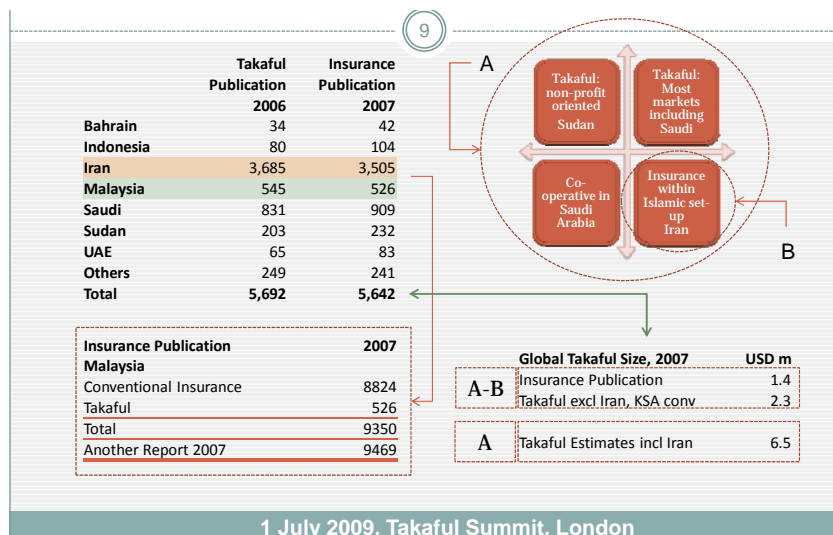
When it comes to calling ourselves 'TAKAFUL INDUSTRY' what exactly does this mean? I have recently come across a definition in a well respected Insurance publication that separates 'takaful' from 'Islamic insurance'. Does it mean that Takaful is not Islamic Insurance? According to it, Islamic Insurance is practiced in several ways. One of them is 'takaful as we know it, in most of the Middle East, Asia and Africa ', second type is what now exists in Saudi Arabia as Co-operative insurance based on

Shariah principles, and the third type is insurance in Iran that excludes Riba but otherwise is structured on conventional basis. There is a fourth type that is conventional insurance written in Saudi Arabia which by their definition would not fall within Islamic Insurance and one wonders how Saudi Arabia treats that portion of the business.

Depending on the definition of 'TAKAFUL INDUSTRY', the size of the industry in 2007 was either \$1.4 billion, or \$2.3 billion or \$ 6.5 billion. I would argue that if our colleagues on the Islamic Banking and Investment side were to be looking for corporate customers dealing in Shariah compliant insurance business for their Islamic Funds and Sukuks, they would be seeking

customers in the Middle East, Africa and Asia that would include Iran (politics aside). Iran practices essential aspects of Shariah principles in its financial system such as prohibition of Riba. So I would consider 'Takaful' and 'Islamic Insurance' as one and include Iran in it.

Depending on our definition, we are as big as \$1.4bn / \$2.3bn / \$6.5bn in 2007



The second point I would like to make here is the difficulty of getting the data. This slide shows two sources to compute the industry size by contributions. The figure of \$2.3 billion is by using takaful based source that had higher figures than the Insurance Publication. And if we include Iran, the figure is \$6.5 billion for 2007. This publication showed for Malaysia \$526 million takaful and \$8,824 million conventional, total \$9,350 million of insurance and takaful. But another report showed \$9,469 million for Malaysia. Which one is correct? Don't really know.

The Challenges we face as an industry are one of the Letter and the Spirit of the Ethics of takaful; I like to call them the Battle of the Minds and the Battle of the Hearts.

The battle of the Minds is 'Do-able'.

- To be Shariah Compliant in developing products, funds and managing operations
- Setting up new takaful companies with large capital
- Building state of the Art systems
- Education and Training
- Competing for business

What's lacking with the Letter is the Spirit, the Battle of the Hearts.

- We can be compliant but how do we remain credible in the compliance of True Ethics?
- Converting 'Conventionals' to 'Takaful'. This is not about asking the likes of multi-national conventional insurance groups to convert. This is about the local and regional players in countries where Islamic Finance is popular or preferred.
- Principles of Dispensation: The ground rules need to change.
- We can educate and train staff, but we need its proper and effective application to increase overall awareness and consumer acceptability.
- And how do we orchestrate as an industry to spread takaful amongst all the OIC countries?

The Principle of Necessity is to allow some flexibility in dealing with issues that would otherwise hold back the development of Shariah compliant system; however this should not be to the extent of diluting the system that reduces the thirst to innovate and ignore valid approaches that can encourage better Shariah solutions to develop and expand the system.

Why do we continue to exercise the principles of necessity indiscriminately?

Short cuts are being taken in the industry and the Fault Lines are clear:

- Many of the decision makers in takaful companies still have conventional Mind sets.
- We have very busy Shariah Scholars.
- And there are too few Shariah Scholars.
- There is lack of Shariah standards at Regulatory level.

Shariah Screening: We need more than that... a follow through to continue the essence of Screening aligned with Ethics of Socially Responsible Investments.

Once we select a company through our screening process, how often do we review if its operations are still compliant? This not

about the gearing element related to Riba, but more about operational aspects of the invested asset that should remain within the parameters of socially and environmentally responsible activities. There may be business opportunities for the company in which we have invested in, that may challenge the biodiversity, it may involve it in human rights abuses, it may directly or indirectly have an adverse impact on the carbon footprint that may contribute to the destruction of our green planet, its flora and fauna and hence ruin the quality of life of societies and communities as has been happening in some parts of South America and Africa. We would invest in such companies initially when such abuses are not there and we would actively pursue through the mechanism of Shariah screening process the removal of such abuses. This would ensure that these companies stay on the right track in reducing and removing the carbon footprint that would make communities and societies happy and healthy. This is the very

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Weak Takaful Ethics
Battles of Heart

FAULT LINES

- Conventional Mind sets
- Very busy Shariah Scholars
- Too few Shariah Scholars
- Lack of Shariah standards at Regulatory level

Zarurah & Ethics of SRI

- Takaful companies in different parts of the world still reinsure conventionally or have conventional reinsurers as leaders of their reinsurance programs. **Why?**
- Short cuts apply to Shariah screening of assets as well. **Why?**
- 'Ethical' is the very theme of Shariah criteria, like the ethical use of money channeled into businesses that are good socially and environmentally. And yet we don't market ourselves as Ethical besides being Islamic. **Why?**

Current Effort

GAP

Biodiversity challenged Human Rights Abused Greenhouse gas emissions Destroying flora and fauna

nature, the intrinsic quality of Islamic Finance in making sure that our planet remains good and green.

'Ethical' is the very theme of Shariah criteria, like the ethical use of money channeled into businesses that are good socially and environmentally. And yet we don't market ourselves as 'ethical' besides being 'Islamic'. We simply sell takaful as insurance and do not highlight enough its ethical qualities. **Why?**

So, how do we ensure that takaful develops into a big and powerful ethical system?

- We have Smaller Universe of Islamic Funds
- Smaller Universe of Takaful Companies
- And yet, large Universe of people who want Ethical Products

The misuse of the principles of Zarurah must stop and at the level where 'Ethics of Corporate Governance' is supposed to be managed, Shariah Scholars have the responsibility to be forceful with the Board of Directors and Management for any misuse.

We have Shariah Rating Agencies, but these need to achieve international recognition and acceptance by the industry and regulators. The Technical Rating Agencies should work with them and a rating for a takaful company should be seen to be incomplete without the Shariah Rating. This would achieve the following:

- Better consumer confidence
- Better promotion of Shariah ethics
- Better Corporate Governance in enforcing compliance

This would go a long way in ensuring Shariah credibility of takaful operators as illustrated in the following example:

Company A: Technical Rating: AA	Shariah Rating: A+
Company B: Technical Rating: AA	Shariah Rating: C -
Company C: Technical Rating: B	Shariah Rating: A+

Company A would fare much better as a compliant company than company B, and Company C would equally have good opportunities to grow and compete than Company B.

Lack of takaful awareness is a big issue for the industry:

- Takaful awareness is patchy, except in Sudan, Malaysia and GCC to some extent
- The word 'takaful' is not known to many people

CEO's of some Takaful companies are still stating in their Annual Reports that there is Lack of Awareness about Takaful. But when you look into what they have done to alleviate this, there is not much to see.

For how long will this continue?

And here is the conundrum, the mystery, the challenge. Takaful is insurance and we sell it as insurance (as it should be). But takaful actually is not just insurance. It is more than that, for all its ethics.

The big players are setting up dedicated takaful operations and that is absolutely great to enlarge the size of the industry. But how openly, how actively are they promoting takaful as 'Ethical'? The conundrum is that if they have both takaful and conventional companies operating in the same market, will they ever be able to promote takaful as ethical in that same market where by default conventional becomes unethical?

Takaful's role in serving the poor masses:

If takaful is all about social goodness and it brings solidarity through mutual assistance and co-operation amongst groups of people, then it is the ideal way to appeal to those sections of our society who normally cannot afford the luxury of financial protection. Micro takaful can be part of the National Agendas to alleviate poverty amongst masses of people in so many countries. There are ***more than 4 bn people who live on less than \$2 a day!!***

The goals of the United Nations Millennium Development Plan are to achieve the following by 2015:

1. To halve the number of people with income <\$1 per day
2. To halve the number of people suffering from hunger
3. To ensure children are able to complete primary schooling
4. To ensure equal schooling for girls
5. To reduce by 2/3rd the under-5 mortality rate

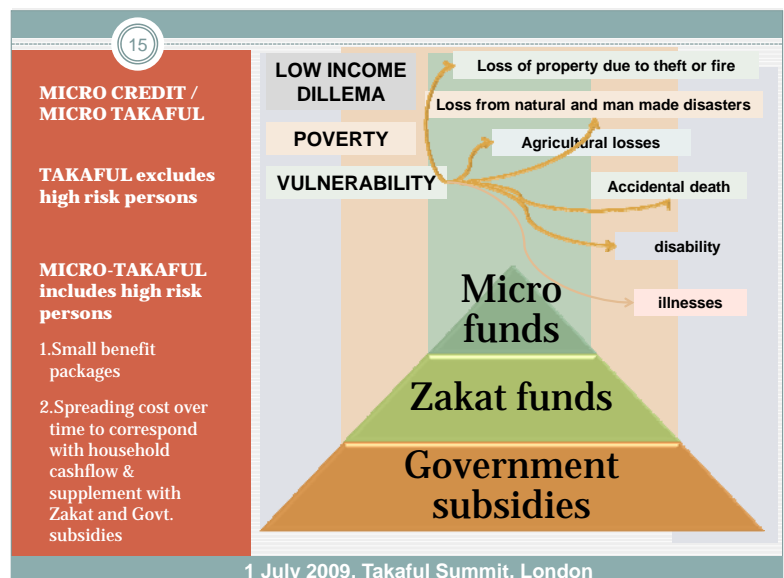
The OIC countries should make micro-takaful and micro-credit as part of these goals.

I like to share one slide on micro takaful. The difference between takaful and micro takaful is that takaful deals with Manageable Risks for those who can afford them. Micro takaful does the opposite. To contain and quantify risks under micro takaful, the benefits have to be small and the cost has to be spread over time payable by households and affinity groups linked to income producing ventures. These could be related to agriculture, industrial production and cottage industry linked to local culture of communities etc.

The ‘unmanageable risk’ comes from a) low income dilemma, b) Poverty and c) Vulnerability, which is about:

- Loss of property due to theft or fire
- Loss from natural and man-made disasters
- Agricultural losses
- Accidental death
- Disability
- Illnesses

The challenge to succeed in micro takaful is how to contain the cost of developing and operating the system. In practical terms, funds generated from micro takaful may not be sufficient to cover



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everything. It may need additional funds, such as institutionalized Zakat funds and government subsidies to provide effective and comprehensive financial protection to the poor masses.

So, recapping the challenges beyond the tipping point, we have the macro challenges where we need to review and reassess where we are and how we see the industry growing into the future.

The credibility of vital industry statistics is an absolute must, but it cannot be done unless there is concerted effort towards greater transparency and ease of access to statistics. A global regulatory standardization of takaful would greatly help this cause.

Shariah credibility is a must to promote ourselves for the social goodness, for its ethics and allow dispensation only in very rare cases. For this, we have to work on strengthening and extending the screening process of investments, redefining Zarurah principles and have a universally acceptable Shariah Rating System.

We need to change our mind sets, a paradigm shift from small is beautiful to big is powerful (and beautiful too) – enlarging the size of Islamic Financial System, facilitating micro takaful. For this we need to lobby IDB and OIC more effectively for supporting growth and expansion of takaful.

It is not just their responsibility but their burden to deliver, especially in micro takaful.

Thank you.

Takaful Dilemma	
Recapping	
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Macro Challenges	Global Challenges
<ol style="list-style-type: none"> 1. Credibility of Vital Industry Statistics 2. Shariah credibility for social goodness and avoiding dilution of principles 3. Need a paradigm shift from small is beautiful to big is powerful (and beautiful too) – enlarging the size of Islamic Financial System, facilitating micro takaful. 	<ol style="list-style-type: none"> 1. Concerted effort towards regulatory standardization 2. Need a) good mechanism for SRI compliance, b) redefining Zarurah principles, c) Universally acceptable Shariah Rating 3. Lobby IDB and OIC more effectively for supporting growth and expansion of takaful. It is not just their responsibility but their burden to deliver, especially in micro takaful.
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