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Risk Management and Disclosure in Takaful Practices

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An Overview of Risks in Conventional Insurance

- General –risk arising from various kinds of hazards
 - Life-Mortality risk with additional risks associated with savings and investments
 - In conventional insurance, all risks are transferred to the insurance operator from the contract holder
 - Liquidity-inability to meet obligations
 - Operational-risk of failures or breakdowns in internal systems and procedures
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- Takaful undertakings are both concerned with the above as well as special considerations as discussed in this presentation

Comparison between Conventional and Mutual insurance and Takaful

	Conventional	Mutual	Takaful
Contractual Relationship	Exchange contract between policy holder and insurance company	Risk sharing by the policy holders, within the mutual company	A combination of a Tabarru' contract and contractual relationship between the participant and TO (Wakala and/or Mudarabah)
Responsibility of policy holders/participants	Policy holder pays premium to the insurer. Surplus and deficit are from the account of the insurer	Policy holder pays premiums to the mutual pool Surplus and deficit are for the account of the policyholders. Surpluses can be retained in reserves to pay possible future deficits	Participants pay Tabarru' and in the case of life takaful, an element of savings Surplus can belong wholly to the participant or depending on the contract adopted, the TO may participate in the surplus
Liability of Insurer/operator	Insurer to pay claims from underwriting funds and if necessary, shareholder funds	Mutual pool is liable to pay claims	Claims are paid from Takaful fund. In the event of such funds not being sufficient, a Qard Al Hasn should be made available
Access to Capital	Access to share capital and subordinated debt	No access to share capital but possible use of subordinated debt	Access to share capital by TO and Qard Al Hasn
Investment of Funds	No restrictions except those imposed for prudential reasons	No restrictions except those imposed for prudential reasons	Assets are restricted to Sharia compliant funds

A Typical Takaful Structure

- A typical Takaful operation can be defined as a hybrid consisting of both a mutual underwriting pool on behalf of the participants and an Islamic commercial operation belonging to the Takaful operator
- A Participant makes a Tabarru' (contribution) to a common underwriting pool
- In Life Takaful, the contribution could also consist of an element of savings or investment which is not considered as Tabarru' or part of the common underwriting pool
- Typically a Takaful operation is managed under a Wakala, Mudarabah or a combination of both contracts. This presentation does not look at the details, benefits or possible contradictions of using one contract over the other.

Fundamentally Takaful risks fall partly on the participants and on the Takaful Operator

- A Takaful operator is NOT exposed to underwriting risks. In a Takaful operation, these are borne entirely by the participants
- All client investments risks are borne by the participant
- Business risks fall on the Takaful Operator

Risks in a Takaful operation fall under the following headings

- Underwriting risk
- Investment risk
- Governance and operational risk
- Reputational risk
- Compliance with Sharia rules risk
- Business continuity risk

Additional issues relating to a Takaful Operation

- In Takaful, Islamic legal contracts are the basis of the relationship between the TO and Policyholder
- The TO's responsibility is to manage the operations on behalf of the policyholder
- Tabarru's is the principle concept which is fundamental to all Takaful schemes. This concept allows the forgiveness of Al Gharrar (uncertainty) which is inherent in all insurance operations, be it Takaul or conventional.
- Conventional insurance includes elements of Riba at all levels- Shareholder funds, underwriting funds or savings funds investments. Takaful funds at all levels are Riba free
- In mitigating risks, Takaful should use retakaful wherever possible. But where such facilities are limited and with SAB approval, reinsurance can be utilised until retakaful becomes available

Managing Risks in Takaful

A Takaful Operator is required to manage risk at two levels

- Underwriting and investments risks of the Takaful funds and participants savings and investment funds
- The Fiduciary, Business and Operational risks to which the TO is exposed as well as the investments risks associated with the shareholders assets

Possible conflicts arising between underwriting and business risks

- TO is responsible for managing underwriting risks by exercising due diligence in accepting such risks, avoiding risk concentrations, setting contribution levels that properly reflect the risks being taken and making appropriate use of reinsurance
- Potential poor TO management of the above could spread to a fiduciary or business risk resulting in a Qard Al Hasn
- TO should have in place an effective fiduciary risk management practices in respect of the relationship between itself and the participants
- TO needs to have effective underwriting (actuarial) risk and investment risk practices and procedures in place
- TO needs to ensure it has in place effective liquidity risk management procedures to pay all claims and responsibilities
- TO should ensure full adherence to all Sharia rulings to ensure reputational risk is not damaged.

Such techniques above require the following:

- Standards and reports
- Underwriting authority and limits
- Investment guidelines and strategies
- Incentive contracts and compensation

Underwriting Risk

- TO must ensure that Sharia principle relating to equity and fairness apply
- TO needs to ensure all participants are treated as “equal”-ratings may apply
- TO needs to manage underwriting risks from both a contractual and prudential perspective
- Underwriting procedures must be in place to ensure TO may decline risks if necessary

Participants need to know how TO would deal with the following

- Is a Qard compulsory?
- What happens if the TO suffers unexpected losses due to misconduct or mismanagement?
- Is support permitted from the Takaful participants funds?
- If a TO is wound up, would participants funds be “ring fenced” from claims of other creditors?

Investment Risk

- TO should use techniques for managing market risk, as used in conventional insurance, subject to Sharia restrictions on investments
- An independent pricing group should be established to ensure correct marked-to-market where there is limited secondary market for such assets
- There needs to be strict rules on the types and levels of assets that can be held in a Takaful fund
- Investments in illiquid investments should be very carefully monitored

Governance and Operational Risk

- The IFSB has already published detailed Governance guidelines for a Takaful operation. These should be adopted to reduce risk in this area
- These guidelines can be reviewed in detail on the IFSB web site
- Operational risk covers both the participants and the TO itself
- Mismanagement of a Takaful operation can expose a TO to potential financial loss through litigation, fraud, theft, lost business and wasted capital

Reputational Risk

- Takaful must protect itself from any criticism leveled at the conventional insurance industry and uphold the Sharia rulings applied to the industry
- TO's should draw on in-house or external Sharia advisory board members to review and audit their operational dealings to ensure adherence to Sharia standards
- TO's should ensure all staff are trained in key business policies and procedures that require observation of Sharia rules and principles.
- Know your customer, anti-money laundering, code of conduct and CG guidelines should be adhered to at all times

Compliance Risk with regard to Sharia Rules

- This is very closely associated with reputational risk, as can be seen in the previous slide
- Formal systems of compliance must be put in place
- A formal Sharia audit as noted earlier
- A CG committee, reporting to the board should be established
- Adherence to local laws and insurance regulations within the Sharia rulings dictated by the Takaful SAB

Business Continuity Risk

- TO needs to develop and manage its business continuity risk
- Possible loss of senior offices
- Develop plans for ensuring knowledge of key individuals is not lost
i.e. actuarial science, Sharia
- Development of a succession plan
- Interference in a Takaful operations IT functions-plans should be developed and tested on an ongoing basis
- In this ever growing and competitive market, retention of key staff is essential

Concluding Remarks

- There are similar risks in both the Takaful and Conventional insurance markets
- Takaful may also borrow risk management techniques from the asset management industry
- Additional risks, associated with a Takaful operation, bring increased responsibilities to the TO
- Risks inherent in the Takaful funds and in the TO itself may overlap, but controls for each level of risk can still be addressed through specific mechanisms
- Feed “lessons learned” back into the ongoing risk management processes

Thank You

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