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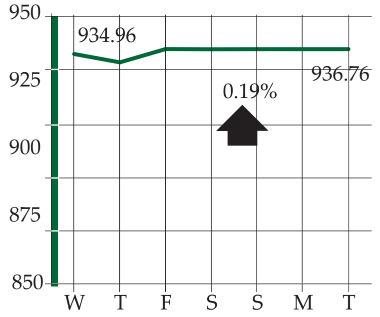

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Can Islamic finance save Pakistan from economic disaster?

Pakistan is a country beset with political difficulties and teetering on the edge of an economic precipice, averaging just 2.9% growth over the past four years and with a fiscal deficit for 2012 running at almost 9% of total GDP. With elections coming up in May and tensions running high, the country is struggling to stay afloat both financially and politically. Yet amid this sea of troubles the Islamic finance industry has surged ahead, reporting an average 30% annual growth rate over the past five years and backed by consistently strong government support. Could Islamic finance be the saviour to rescue Pakistan from its economic quagmire?

A nation in trouble

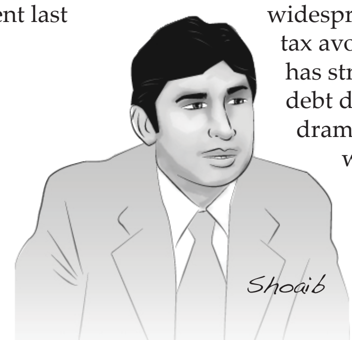
Pakistan's political difficulties are well-documented, and the country continues to suffer: with the recent arrest of prime minister Raja Pervez Ashraf on corruption charges, mass protests demanding the resignation of the government and a spate of militant bombings as the Kashmir border conflict with India continues to escalate. In addition to the political tensions, the country has experienced a seriously deteriorating economy over the past few years, and is expected to ask the IMF for a new aid package this year. "Deep-seated structural problems and weak macroeconomic policies have continued to sap the economy's vigour," said the IMF executive board in a statement last November.

The IMF has predicted that foreign reserves in 2013 will be half what they were in 2011, reflecting declining investor confidence and a worryingly sluggish economy. A recent survey by Pew Global Attitudes found that 90% of Pakistanis think their economy is in a bad state, while 57% say they are worse off than five years ago. With the economic problems only contributing to the social unrest, the situation is getting serious.

Muhammad Shoaib Ibrahim, CEO of First Habib Modaraba, warns that: "We have a lot of challenges in the country. The weak political set-up is the main problem, but we also urgently need good quality people — there is a severe shortage of talent. Other issues are the extremely high inflation and the poor governance and weak law and order. This is continuously hammering the industry and preventing the expansion of the economy."

Economic crisis

Growth has averaged just 2.9% over the last four years, with a minor increase to 3.2% expected for 2012-13. At the same time inflation has soared, averaging between 10-20%, while the government deficit last year stood at a record high of 8.6% or around PKR1.77 trillion (US$18.03 billion). The government, exchange commission and central bank have resorted to financing the deficit through printing money, and in the past year over PKR500 billion (US$5.09 billion) has been printed.



With tax revenues just 9% of GDP due to widespread corruption and endemic tax avoidance, the government has struggled to service this debt domestically, resulting in a dramatic rise in external debt which has increased the cost of debt repayments and thus decreased funds available for much-needed

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From conventional to Takaful: Strategic considerations in Afghanistan

The insurance market in Afghanistan is in its infancy and largely under-developed, yet has enormous potential for growth. ALBERTO BRUGNONI describes the recent activities in Afghanistan towards developing a domestic Takaful industry.

This article describes the activities performed during a four-month stint (June to September 2012) spent in Kabul with the remit to write a Strategic Appraisal for Takaful; discuss regulatory guidelines with the Afghanistan Insurance Authority; and build capacities and develop products for the four insurers active in the country. The Islamic Republic of Afghanistan is in a unique situation as conventional insurance is at its inception while Shariah compliant products for General Takaful — where an exceptionally strong pent-up demand lies in waiting — are struggling to create their own breathing space.

Assessment of the market

The Afghan market is mostly made up of general insurance, with property and casualty-liability forming its backbone. Commercial lines include transportation — as virtually everything imported arrives into this landlocked country by road; aviation; construction, mining and engineering; motor fleet; property; liability; and other lines such as logistics, security, equipment and telecoms. Personal lines include home insurance — providing cover for building and contents against fire, accident and allied perils; health cover, both group and medical; car insurance which is compulsory; banks and financial institutions to cover the repayment of a loan in case of death of the borrower. Most of the domestic personal lines are group insurance and form a large market though with small premiums, whereas large local exposures — such as banks, airlines, ISAF, UN agencies — insure their personnel abroad. The life insurance market is utterly under-developed and provides a lump sum payment in the event of the death of the policyholder with cash benefits linked to salary and/or loan commitments.

To evaluate the annual premiums is extremely difficult as most of the commercial lines are non-admitted insurance (though the direct purchase of policies from an overseas insurer is a breach of law and subject to punitive actions) and even some of the business underwritten domestically is fronting. Therefore, the total figure of more than US$10 million reported by the Afghanistan Insurance Authority for the year 2011 is a gross underestimation. Small losses are handled locally whereas larger ones require the assistance of international claims adjusters, mostly based in Dubai. Business is placed directly with the prospects as there are no brokers or agents and advertising is carried out with very large billboards. Some companies also have regional offices. Reinsurance is mostly placed into the London market, particularly at Lloyd's, some of whose syndicates back various lines in different companies. Ten to 15% of large risks are, on average, retained.

> ***"The impending changes in the Afghan economy will have important consequences on admitted insurance business for the growth and extension of its business lines"***

Regulator and players

The market is regulated by the Afghanistan Insurance Authority (AIA) which sits under the umbrella of the Ministry of Finance. Regulations include the 'Insurance Procedures to Accompany the Insurance Law of the Islamic Republic of Afghanistan' (2008) and the 'Insurance Law of the Islamic Republic of Afghanistan' (2009). A draft of the new law on insurance is at present under discussion in parliament. The AIA has also issued specific regulations on civil aviation, third-party car liability, and others. There are no regulations specifically addressing the Takaful market. Four companies operate in the country: the state-owned Afghanistan National Insurance Company (ANIC), established in 1964; the Insurance Corporation of Afghanistan (ICA), established in 2008 by a group of experienced Afghan and international investors; the Afghan Global Insurance (AGI), established in 2010 and owned by local investors and businessmen; and the Insurance Group of Afghanistan (IGA), established in 2012 by a well-known Afghan conglomerate.

A very positive outlook

The outlook for the conventional insurance and Takaful is linked to the growth of the economy which, in turns, hinges on the development of the mining industry. Afghanistan is one of the countries with the richest and biggest intact mines in the world and the exploitation of its resources, which include all minerals that are essential to modern industry, could indeed make it the richest mining region on earth. The findings of a 2010 report published by the US Geological Survey, in conjunction with the Ministry of Mines and Minerals of Afghanistan, conservative valuing these resources at US$3 trillion, have fundamentally changed the geo-political standing of the country.

The impending changes of the Afghan economy will have important consequences on admitted insurance business for the growth and extension of its business lines. On the one hand, General-commercial Takaful will be used to tackle risks as most of the financing needed will be raised Islamically through Sukuk issuances, Shariah compliant PPP and hybrid structures. On the other hand, the

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development of key sectors of the economy will reverberate through a society still largely composed of rural and traditionally-minded communities and bring to the fore a middle-class with growing expectations. General-personal and Family Takaful — a culturally accepted way to insure but also to plan for the future and accumulate wealth — will help managing and accommodating social changes.

Hurdles to development

Regulation is quite basic and still under development with a new law pending at present, and the need for a regulatory and legal framework for Takaful widely acknowledged. With only four highly populated areas in the country (Kabul, Kandahar, Herat, and Mazhar) and most of the population living in rural, difficult-to-access areas, market penetration is also a challenge. More importantly, the divide between the haves and have-nots shows no sign of abating and the swelling professional class is not evolving into a middle-class (a natural recipient for insurance products) with reasonable purchasing power.

Furthermore, the unreported economy (black economy and mattress finance) that some sources estimate at a staggering three to four times the official GDP, shies away from any kind of insurance, lest it be screened by the authorities. Lack of awareness and participation also plays a role as the very concept of insurance is new and has to elbow its way into people's minds. Furthermore, the insurance market faces the same difficulties as other professions in Afghanistan: sourcing, retaining and training an adequate workforce with enough education and longevity to establish a platform for growth. A positive development is that banks are, though slowly, starting insuring their financing.

Last but not least, cultural and religious acceptability is an issue as this multi-ethnic and multi-lingual society is unified by Islam which is the religion of more than 99% of the population. Islamic practices pervade all aspects of life and Islamic religious tradition and codes provide the principal means of controlling personal conduct and settling legal disputes. Excluding urban populations in the principal cities, most Afghans are organized into tribal and other kinship-based groups, which follow their own traditional customs. This is why the very concept of conventional insurance is deemed unacceptable by large swathes of the population.

The way forward

The following three recommendations are being implemented by the relevant stakeholders. An actionable regulatory framework to allow the opening of Takaful windows and, at a later stage, the establishment of stand-alone companies, coupled with the interaction with local Shariah scholars to ascertain which model of Takaful is preferable under local rules and customs. The creation of a knowledge center to satisfy educational and capacity-building requirements with a particular focus on the following building blocks: segregation and treatment of funds, product design and pricing, distribution of surpluses, actuarial concepts and actuarial control cycle, claims management, financial and capital management, regulations, risk management, Takaful contracts and underwriting, valuation of liabilities, product distribution and servicing, emerging issues and re-Takaful. Finally, the proper conception, marketing and execution of the products lest the existing negative image of conventional insurance amongst the Afghan population spills over into the Takaful proposition

A Takaful road map

The Takaful product development should first of all aim at personal lines as the domestic retail market is particularly sensitive to religious arguments. Commercial lines should wait until business is financed Islamically. Property (residential, commercial and industrials), where damage is easily quantifiable, is an area where Takaful products are easy to develop. In other personal lines, one should look at group propositions (as the disposable income is simply not there for individual proposition) and eye those markets where premiums are small but the number of policyholders is great, such as the Afghan public employees that do not have any security and protection. Benefits should include working place liability and health.

Also, there has been, to date, little in the way of effective insurance available to local enterprises. A development strategy should possibly focus on the four or five industrial parks that exist in Afghanistan and on the value chains of specific industries (the textile industry, for instance, is worth US$2-3 billion though only US$250 million is retained in the country). Trucking has to be carefully researched as there are tens of thousands operators though admittedly only a handful with a fleet of two to three thousand machines. The possible development of pension funds (salary contribution scheme) is an area that remains to be tackled as well as Family Takaful which requires the full backing of the Shariah scholars' community due to its religious sensitivity.

Products developed

Three products have been developed. The first one is a Group Family Takaful policy for the 333,260 (as of December 2011) public employees that don't enjoy any insurance protection. The policy is based on a Mudarabah, with life insurance coverage either as a full benefit or with a partial contribution. Benefits include working place liability and health with the possible extension after retirement. Secondly, to insure Islamically properties used as collateral for Islamic financing, the 'front part' of a conventional product already in existence has been Takafulized through a Wakalah contract. It applies to any property deemed to be Shariah compliant (but not to greenfield ventures) and the insured amount is capped at a fixed rebuilding cost agreed upon with the chosen re-Takaful company. This policy insures the property and never the credit and is made compulsory for obtaining financing. The premium is collected by the bank itself and added to the total cost of the Islamic financing and then split between the bank and the insurer after payment to the reinsurer, as the policy is under treaty. Finally, a Fleet Motor Plan under treaty in London has been Takafulized with a policy based on a Wakalah contract whose benefits include damage to the car and liability to third parties.

Alberto Brugnoni is the managing director of ASSAIF. He can be contacted at alberto.brugnoni@assaif.org.