

> The risk-reward relationships that govern the investment decisions of Takaful companies and their conventional counterparts are similar as both groups insure their participants against the same kinds of risks with the additional constraint for the Takaful companies of Shariah-compliance. It is also true that Takaful companies, like conventional insurers, have fiduciary responsibilities vis-à-vis their customers similar to those of a quasi-trust. As such they must take reasonable care to safeguard the assets and therefore their overall risk tolerance is on the lower side. But Takaful companies have a clear segregation between the funds of the participants and the funds of the shareholders; therefore it is possible for them to have two separate investment strategies, the latter being slightly more aggressive than the former.

The investment objective that is governing the investment strategy and asset allocation decisions is a function of the product mix of each Takaful company and may differ slightly

for family and general Takaful companies respectively, as the underwriting cycle, liquidity requirements, time horizon of liabilities, tax considerations, regulatory considerations, and, therefore, the return requirements and risk tolerance are different. The investment objective is, of course, to generate enough return to meet claims adequately, and to grow the surplus at the same time. The objective should be fine-tuned and made specific with regard to unique circumstances of every company. The constraints will help define the risk tolerance of the portfolio. Together, the investment objective and constraints can help quantify the company's return requirement and its risk thresholds

Takaful lags conventional insurance in market penetration

It is a fact that Takaful products have limited penetration even within core customer segments which is partly explained by Takaful players inability to create the same level of excitement among clients as achieved by Islamic banks and in part because Shariah compliant funds have provided lower returns and slightly higher risk over time than their non-Shariah compliant counterparts. Takaful institutions, similar to conventional insurers, need a wide variety of products to effectively manage their risk-return targets for their investment portfolios. Presently, the Islamic investment management industry is still evolving and product depth and geographical diversification are major obstacles to effective asset allocation. So it is imperative for Takaful players to develop 'value added' products in investment management to remain competitive. Strategies that successfully combine Shariah-compliant risk-adjusted returns with actuarial analysis are required to meet claims and ensure profitability of an operator. This is especially true of shareholders' funds and of family Takaful, where both shareholders and participants seek long-term returns on their equity and contributions. As the Takaful industry grows and family Takaful becomes more prominent, Takaful operators will collectively emerge as significant institutional investors. In this scenario, outsourcing of

Takaful and conventional insurance

by Alberto Brugnani

Reassessing investment strategies and asset management approaches for Takaful operators. Mezzanine finance for care comes as an effective alternative asset class

the asset management function provides considerable opportunity for specialised managers and the market will have to move towards the so-called 'liability driven investment benchmarking'. These issues were highlighted during the debate at The World Takaful Conference when the existence of 'a gap in asset management' was repeatedly mentioned.

The case for Alternatives

One of the ways to address these issues is to broaden exposure and capabilities to multiple assets classes. One of the things we learned from the just published 'E&Y Takaful Report 2009' is that the risk landscape has changed substantially over the last year with investment portfolios and financial risks moving from 4th to 1st with the restricted investment universe, unbalanced investments, high counterparty risk and reduced Sukuk issuance cited as contributing factors. Investment options available to Takaful companies typically consist of the standard four broad asset classes: cash, fixed income, equity, alternatives. While the three first classes offer reasonable wide investment opportunities, the alternatives are the neglected little brother. They are, by common wisdom, thought to be illiquid, higher-risk and longer-tenor investments and thus unsuitable for inclusion in a Takaful company's portfolio in large proportions, especially for the participants' funds. But a closer look can perhaps offers a different perspective. The case for alternatives is also supported by modern portfolio theory, for example the Efficient Frontier (also known as Markowitz Frontier), that is the base for optimising returns even for Takaful companies. The Efficient Frontier is simply a plot of portfolios that provide the highest return for each risk level, or alternatively put, portfolios that provide the lowest risk for a given return level. Each portfolio on the efficient frontier is comprised of a particular combination of the four asset classes. Now, if we measure risk as standard deviation of returns we can see that at present some alternatives prove, without question, far better than the three other asset classes.

A tangible Alternative: combining bricks with Care Homes in the EU

What we are analysing here is the investment via mezzanine finance in those nursing homes in which rents are derived directly or indirectly from government sources. It is a fact that funding for residents of nursing and residential care homes in Europe largely comes from government authorities which are increasingly relying on private operators to supply necessary services. As demand for long term care beds will continue to outstrip supply and some of the current capacity will be lost due to the closure of substandard facilities it is believed that nursing homes are unlikely to experience a material decline in valuations. A number of favourable trends are also having the upper hand. One can mention demographic trends with ageing population all across Europe, families disruption and increase focus on quality of life for the elderly. Supportive public social policies for large sectors of the population accompanied by public agencies slowly retracting and devolving management to private sector. Absence of dedicated major players with ownership fragmentation of care homes and the emergence of major consolidations opportunities. Movement toward categorization and specialist care with elderly, specialist adult and child long-term homes. Exiting of the market by players that were in just for tax breaks reasons. Last but not least, investment in this sector will allow to move from halal to tayyeb policies

The provision to the owner of Care Homes with funding in the form of mezzanine finance is today yielding investors a 9% annual cash coupon as part of a 20% bond equivalent yield. ■



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