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Different Takaful Business Model in Practice
- Concept and Modalities

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Why not Insurance?

Why conventional insurance is not *Sharia* compliant

- From the insured perspective
  - Insurance is a (pure) risk transfer mechanism, the insured loss is restricted to his premium
  - Insurance companies investments are not in *Sharia* compliant assets (e.g. interest bearing bonds, investments in prohibited businesses)
  - Certain insurance products may lack transparency (e.g. how much is the insurer charging for managing the policy is not known to the policyholder)
- From the (insurance) investors perspective
  - Underwriting profits are subject to an element of chance (speculative risk)
  - Investments are not *Sharia* compliant

Basis of operation of a conventional General Insurance company

- There is typically no identifiable policyholders fund
- Premiums once paid becomes part of the assets of the company. The company in turn becomes liable to pay all insured claims arising
- All investment income on these assets and any underwriting surplus or losses accrue to the shareholders of the company
- Policyholders typically do not know how much of his premium goes towards claims, expenses and profit to the company
- Only restrictions on investments relate to the Asset Liability Management constraints imposed by management and/or Regulators

Takaful - The building blocks

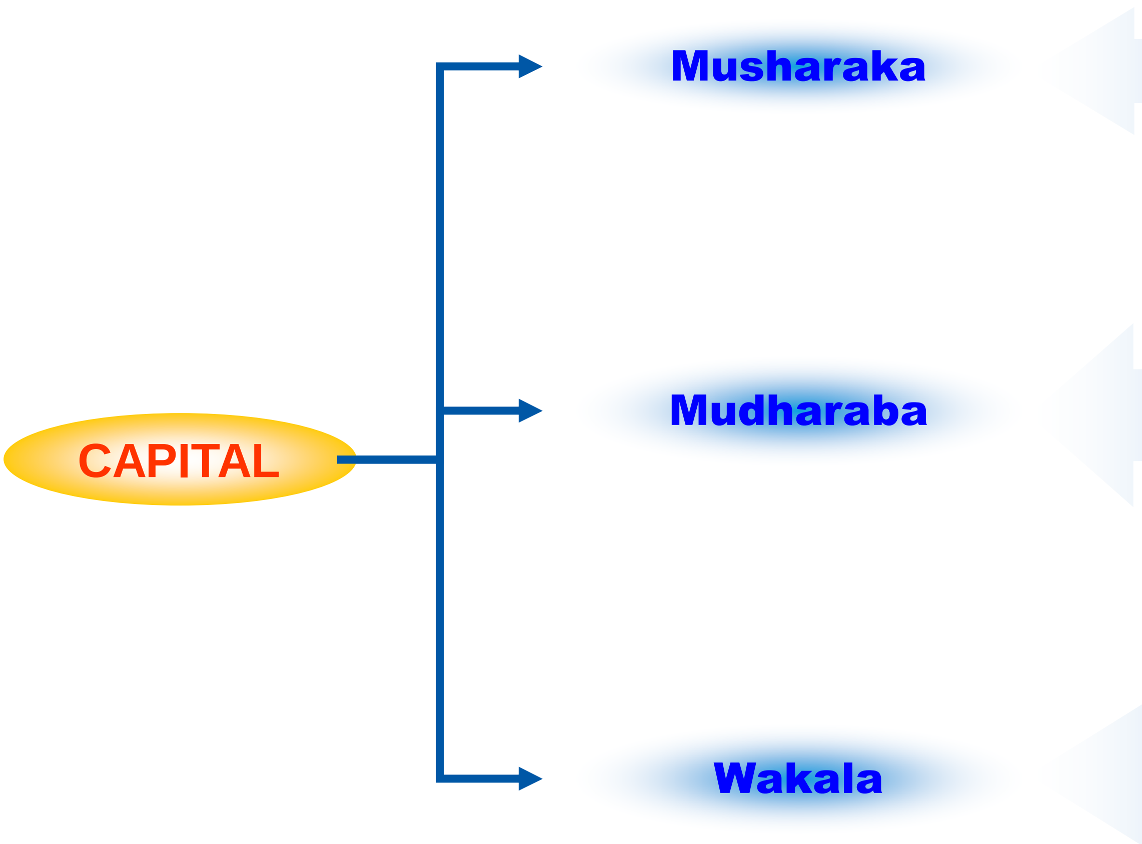
What enabled the establishment of *Takaful*?

- The Islamic *Fiqh* (Muslim Jurisprudence) Academy under the auspices of the Organization of Islamic Conference ruled in 1985 that : "Insurance through the concept of a **cooperative** (founded on the basis of ***Tabarru'***) is acceptable in Islam"
- This is the basis of modern Islamic Insurance where the insured is also the insurer (**risk sharing rather than risk transfer**) and *Gharar* is overcome through premiums being *Tabarru'.*

The Takaful Fund - Risk

- *Gharar* (uncertainty) is present in any insurance type arrangement. When you buy an insurance policy you may or may not claim from the insurer depending on whether the insured event transpired or not during the duration of the policy.
- Premiums are *donated* to the Takaful Risk Fund by the *participants* or policyholders. *Tabarru*’ is a sharia approved gratuitous contract, which by its nature accommodates *Gharar.*

Islamic Contracts of Compensation (sample)



Musharaka: Partnership between capital providers. Profit, shared in an agreed percentage (e.g. Joint stock companies)

Mudharaba: Partnership between capital provider and entrepreneur. The former brings capital, the latter brings expertise/effort. Profit is shared in agreed percentages. **Losses accrue to capital provider only**. Entrepreneur bears his own expenses.

Wakala: Entrepreneur given a **fixed fee** for this expertise/effort. Does not share in profit or loss which accrues to the capital provider. Entrepreneur bears his own expenses.

Sudan’s Takaful Model

Basis of Operation – the Cooperative model

- Set up as a cooperative but with a small shareholders fund to meet statutory requirements. Premiums are deemed to be *tabarru'.*
- All expenses (including management and acquisition costs) are met by the cooperative fund
- All surpluses belong to the policyholders, shareholders returns are restricted to the investment income on the shareholders fund.
- If the shareholders sets up a separate management structure for investing the assets of the cooperative fund, the shareholders will be entitled to a share of the investment profits. **Investment** management expenses are **not** charged to the cooperative fund. Effectively the investment services are contracted out by the policyholders on the basis of the *mudharabah* contract.
- Policyholders are represented on the Board of Directors of the company.
- There is a Sharia Supervisory Board responsible for ensuring the company's operation complies with *Sharia* law.

Malaysia’s Takaful Model

Basis of Operation - the Company / Cooperative approach
The Mudharabah model

- The first Takaful Operator in Malaysia is Syarikat Takaful Malaysia. It has a separately identified shareholders and policyholders (Takaful) fund. It follows the *Mudharabah* model on the basis of the following interpretation of the insurance process;
  - The policyholders are designated as the capital providers to the Takaful Fund
  - The shareholders are designated as the entrepreneur whose tasks is managing the Takaful Fund
  - Surplus arising in the Takaful Fund arises from both the underwriting of risk and the investment of assets and is shared on a pre agreed profit sharing percentage (normally 50:50 for non life operation). All management expenses are met entirely by the shareholders fund. However, all deficits in the Takaful fund accrue to the policyholders only, not the shareholders.

Basis of Operation - the Company / Cooperative approach
The Wakala/Mudharabah model

- The later Takaful Operators opted for the *Wakala* Model for the underwriting portion of the operation. Under the *wakala* contract;
  - The Operator takes a fee expressed as a percentage of the premium. This premium net of the fee is then deposited in the Takaful Fund from which claims are paid.
  - In return for the fee, all management and distribution costs are met by the shareholders fund.
  - Underwriting surplus and deficits accrue to the policyholders
  - Some Takaful Operators take a share of the underwriting surplus as an “incentive” wakala fee while not sharing in the underwriting losses
- Concurrently the Takaful Operators opted for the Mudharabah Model for the investment portion of the operation;
  - The Operator takes a percentage share of the investment income but does not share in investment losses
  - All investment management expenses are borne by the shareholders fund
- For unit linked type of Takaful Life (called “Family”) products the Takaful Operator may choose the *Wakala* model where they take a percentage of the NAV under investment as their fee instead of Mudharabah profit share model
- There are no policyholders representatives on the Board of Director.

Indonesia’s Takaful Model

Basis of Operation – The Takaful Window

- Apart from two companies, all the other takaful operations in Indonesia are “window” based operation.
- Under a window operation a notional takaful fund is set up within the conventional insurance fund. Assets are ring fenced within this notional fund and consists of only sharia approved investments.
- It is notional in that there is no **legal** separation of assets and in any winding up it is doubtful that the assets in the takaful window is provided any protection from the liability of the other (conventional) policyholders
- The dominant Takaful Model in Indonesia is the Mudharabah model for both underwriting and investment business within the takaful operation. However, notwithstanding this model there is provision to treat commissions as a first charge on takaful premiums
- There are no policyholders representatives on the Board of Directors

The Middle East’s Takaful Model

Basis of Operation – Islamic Contracts for Takaful

- The Wakala and the Mudharabah contracts are the choice contracts for Takaful in the Middle East. With some exceptions the Mudharabah contract is solely used only for investments of Takaful Funds
- There is a particularly unique form of the wakala contract practiced by many Takaful Operators in the Middle East;
  - Instead of stating the wakala fee explicitly in each takaful contract, the wakala fee is announced (usually through the printed press) at the beginning of each financial year of the Takaful Operator and is fixed for the duration of the year
- Underwriting surplus, if provided as an incentive fee for the Takaful Operator under the wakala contract, starts at a higher threshold rather than the first dollar of surplus as in Malaysia
- There are no policyholder representatives on the Board of Directors

The Pakistan’s Takaful Model

Basis of Operation – Wakala with Waqf

- While the *wakala* contract still applies between the Takaful Operator and the Takaful Fund, Pakistan's Shariah Scholars raised certain issues with the accompanying *Tabarru'* contributions which is considered as a *conditional gift*;
  - As a *conditional gift*, the contributions are specifically to be used to pay claims with any underwriting surplus still accruing to the *Tabarru'* contributors. Under this assumption there is a concern that the transaction has the characteristic of a contract of compensation. Under such conditions the underlying *gharar* would have invalidated the transaction under Sharia law. There is also the issue of the fairness of intergenerational subsidies between different generations of participants if such ownership links prevails.
  - To avoid such doubts, the *Sharia* proposed the use of an Islamic Trust Fund, a *waqf*.
  - Under a *waqf* the any lingering ownership by the policyholders to the *Tabarru'* contribution is legally severed

Takaful – Towards a viable Business Model

Role of Capital

- Although risks are retained within the Takaful Funds, a mechanism is required to smooth out the expected claims fluctuations
- Under the Sudan Model there is explicit provision for policyholders to contribute additional premiums should a deficit occur. However, this is not usually done in practice. No such provision exist elsewhere.
- Typically, funding of these volatilities comes first through utilization of reserves built from past surpluses and next from loans made from the shareholders funds. These can be seen as **subordinated** *interest free* loans (***Qard*** *Hasan)*
- Loans to be repaid (and are a first charge) from future Takaful surpluses

ReTakaful

- The need for *Qard* can be minimized through appropriate retakaful arrangements.
- Retakaful is different from reinsurance in that;
  - The reinsured is not the TO but instead it is the Takaful Risk Fund
  - The TO acts as the agent to the Takaful Risk Fund to secure the necessary retakaful programs
  - While reinsurance acts to spread the volatility of the insurer over time, retakaful is more akin to a risk pool at a specific time

The Challenges for a viable Takaful business model

- Mudharabah model likely to be limited to investment rather than the underwriting process in Takaful
- Regulators interpretation of the role of stakeholders and role of capital
- General (Casualty) Takaful
  - Easily adaptable for personal lines (high volume with low volatility)
  - Problems of capacity for commercial lines (high volatility) without sufficient Retakaful support
  - Lack of suitable *Sharia* compliant assets
- Life (Family) Takaful
  - Apart for in Malaysia, Family Takaful is still underdeveloped elsewhere
  - What constitute an acceptable Family Takaful product?
  - Limited availability of *Sharia compliant* asset classes imposes a limitation on product innovation

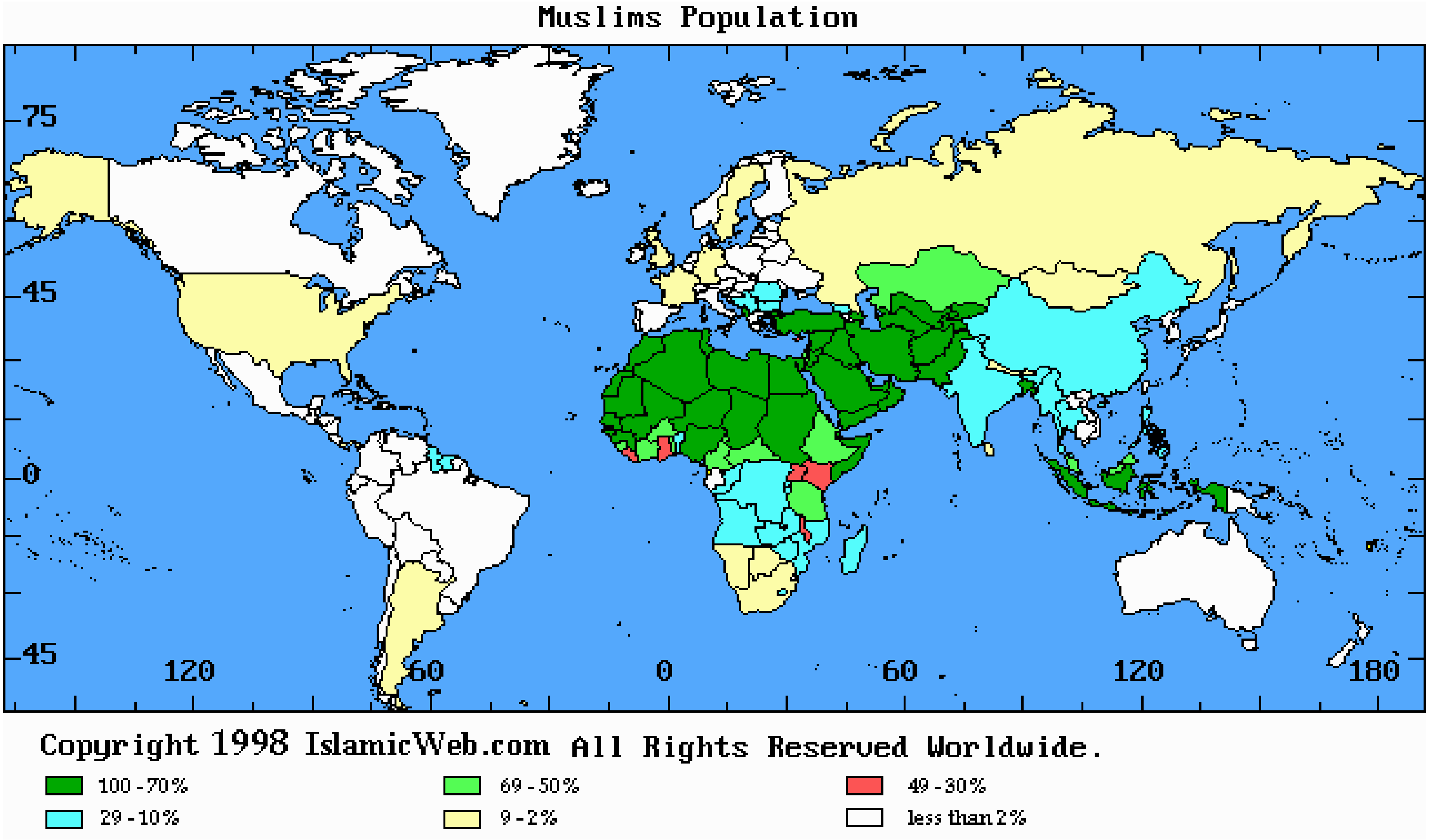
Takaful – The primary target market

The Muslim Population

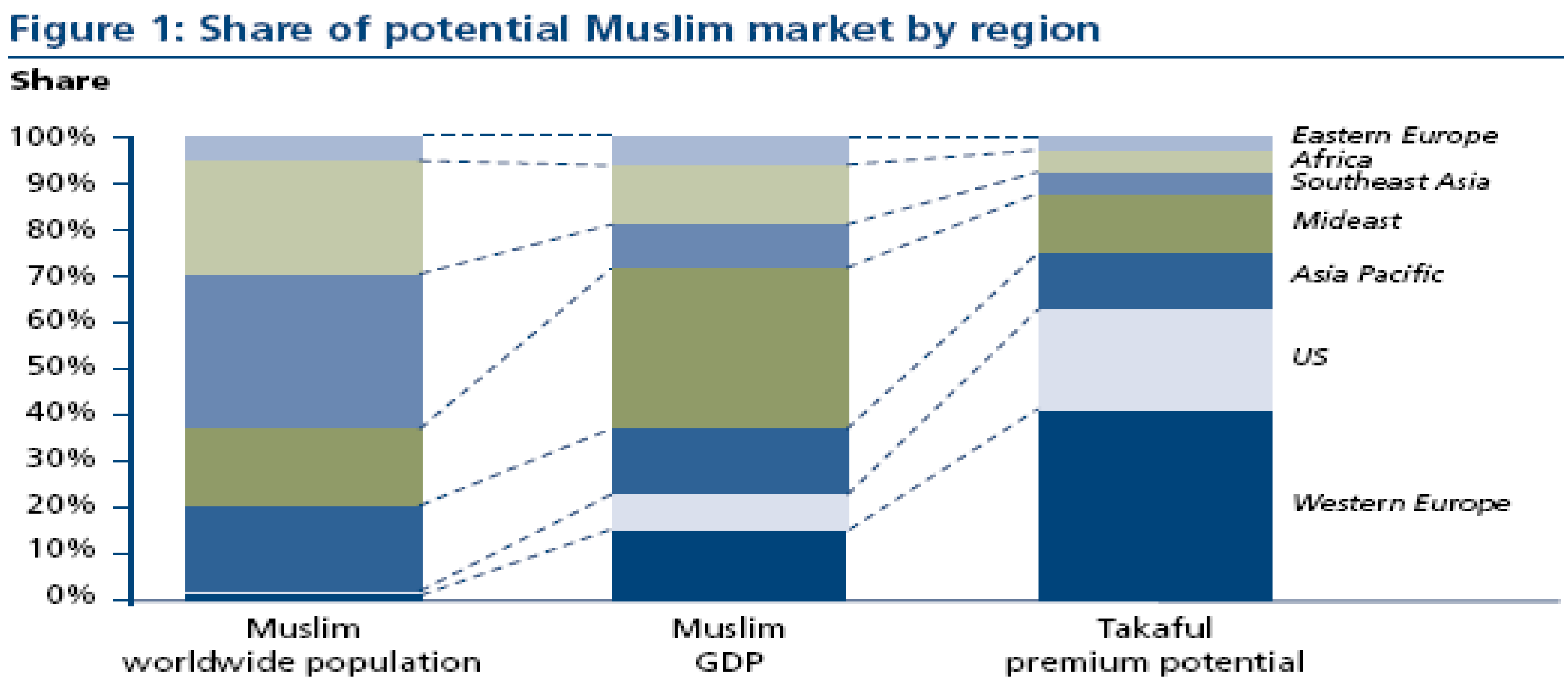
- 1.84 billion worldwide in 2007
- 1.24 billion in Asia (including Middle East)
- 490.9 million in Africa
- 50.7 million in Europe
- Muslim population is increasing at a rate of 2% p.a. around the world.

Source: www.islamicpopulation.com

Muslims make up 1.84 billion of the world's population



Potential Takaful Market by Region



Source: US State Department, Swiss Re, Mercer Oliver Wyman analysis

Taking into account the likely penetration among Muslims, adjustments for non-Muslim potential, there is worldwide Takaful premium potential of at least US$ 20 billion annually, compared to current figure of US$ 4 billion*

**Source: Oliver Wyman in their publication "Takaful: A new global insurance growth opportunity"*

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