



# Realising the Value Proposition of the *Takāful* Industry for a Stable and Inclusive Financial System



ISLAMIC FINANCIAL SERVICES BOARD



WORLD BANK GROUP



**REALISING THE VALUE PROPOSITION  
OF THE *TAKĀFUL* INDUSTRY FOR A  
STABLE AND INCLUSIVE  
FINANCIAL SYSTEM**



ISLAMIC FINANCIAL SERVICES BOARD



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This publication is derived from the conference “*Realising the Value Proposition of the Takāful Industry for a Stable and Inclusive Financial System*”. The views expressed in this publication are those of the author(s) and not necessarily the views of the Islamic Financial Services Board and/or The World Bank.

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# CONTENTS

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<b>OVERVIEW</b>	<b>I</b>
<b>ABOUT THE CONTRIBUTORS</b>	<b>V</b>
<b>OPENING AND WELCOMING REMARKS</b>	<b>IX</b>
<b>KEYNOTE ADDRESSES</b>	<b>XVII</b>
<b>INTRODUCTION</b>	<b>1</b>
<i>Takāful</i> : Basic Concept and Principles	1
References	3
<b>CHAPTER 1: GLOBAL OVERVIEW OF THE <i>TAKĀFUL</i> SECTOR-TRENDS AND POLICY DEVELOPMENTS</b>	<b>5</b>
Introduction	5
The Need for Insurance/ <i>Takāful</i> /Islamic Insurance	7
The <i>Takāful</i> Business Model	9
History of the Development of <i>Takāful</i>	9
Global Trends in Regulatory Initiatives for <i>Takāful</i>	13
International Regulatory Initiatives	15
Key <i>Takāful</i> Markets	16
Regional and Country Developments	17
Global <i>Takāful</i> Business Risks and Challenges	25
Policies to promote the Global <i>Takāful</i> Industry	31
Conclusion	31
<b>CHAPTER 2: REGULATORY DEVELOPMENTS AND IMPLICATIONS FOR THE INDUSTRY - CONTRASTING THE VARIOUS APPROACHES TO REGULATING <i>TAKĀFUL</i></b>	<b>33</b>
Introduction	33
The International Regulatory Architecture for Insurance	34
Regulatory Developments in the Insurance Sector	38
Prudential Regulation	39
Conduct Regulation	47
Key Policy Issues and Challenges for <i>Takāful</i> Regulators	49
Dealing with Failed Operations	53
<i>Takāful</i> Windows	53
Conclusion	54

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**CHAPTER 3: THE ROLE OF MICROTAKĀFUL IN FINANCIAL INCLUSION:  
THE FOUNDATIONAL CLAIMS OF INSURANCE IN ISLAM** **57**

Introduction	57
The Foundational Claims of <i>Takāful</i>	58
Microdelivery in Islam and <i>Microtakāful</i> Providers	60
Capital and the Use of <i>Zakat</i> Funds	62
Capital and the Use of <i>Waqf</i> Funds	65
Regulatory Issues	66
Product Design and Coverage	67
Additional Issues	68
Conclusion	70
References	71
Appendix 3A: Index Insurance in <i>Microtakāful</i> and <i>Fiqh</i> Implications (A Commentary to Chapter 3)	73

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**CHAPTER 4: RISK MANAGEMENT AND GOVERNANCE IN TAKĀFUL** **79**

Introduction	79
The <i>Takāful</i> Concept and Risks	80
Major Risks in Sharī'ah-Compliant Insurance	81
<i>Takāful</i> Operating Models	83
Underwriting: Types and Implications	88
Intention of Shareholders	93
Intention of <i>Takāful</i> Participants	95
Key Challenges Facing <i>Takāful</i>	98
Role of the Sharī'ah Board and the Risks It Imposes	102
Market and Liquidity Risks	104
Family <i>Takāful</i> as a Savings Aggregator	105
What about <i>Takāful</i> Windows?	105
Conclusion	107

---

**CHAPTER 5: CHALLENGES OF RETAKĀFUL: THE LIMITATIONS OF  
COOPERATIVE REINSURANCE AND ITS SOLUTION BY TECHNICAL  
ANALYSIS** **109**

Introduction	109
The Methods of Organizing Cooperative Reinsurance	109
A Mutual Reinsurer	110
Other Forms of Mutuality and Solidarity in Reinsurance	112
The Dilemmas: The Guiding Principles Compared to Practical Experience	113
Risk Sharing and Risk Transfer	116
Where all Dilemmas Meet: Modelling and Pricing	121



<i>Retakāful</i> Commission	129
The Standardisation Proposal: Cutting Through the Gordian Knot	133
Conclusion	140
References	141
Appendix 5!: Challenges in Developing the <i>Retakāful</i> Sector (A Commentary to Chapter 5)	142
<hr/>	
<b>CHAPTER 6: TAKING <i>TAKĀFUL</i> TO THE NEXT LEVEL</b>	<b>145</b>
Introduction	145
Background and Context	146
Trends and Drivers of Risks	147
Conclusion	156
References	157
<hr/>	
<b>CHAPTER 7: SYNTHESIS OF DISCUSSIONS AND WAY FORWARD</b>	<b>159</b>
Introduction	159
Regulatory Regimes	159
<i>Takāful</i> Models	162
Markets, Products and Delivery Channels	164
Corporate Governance	165
Risk Management	166
Other Operational Issues	167
Conclusion	168
References	170
<hr/>	
<b>CONCLUDING REMARKS BY THE IFSB</b>	<b>171</b>
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<b>CONCLUDING REMARKS BY THE WORLD BANK</b>	<b>175</b>
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# OVERVIEW

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This publication contains the outcomes of a conference jointly organised by the Islamic Financial Services Board (IFSB), The World Bank Group (WBG) and the Undersecretariat of Treasury of the Republic of Turkey in Istanbul, Turkey on 30–31 May 2016. This conference, themed “*Realising the Value Proposition of the Takāful Industry for a Stable and Inclusive Financial System*”, was held to provide a platform for global practitioners and stakeholders in the *takāful* (Islamic insurance) industry – including senior representatives of multilateral development institutions, insurance supervisors, *takāful* and *retakāful* undertakings, and academics – to discuss the outlook of the *takāful* industry and its potential for enhancing risk coverage of individuals and corporates, promoting financial inclusion, and supporting the growth of the Islamic finance industry globally. The conference also included discussion of the developments made in the legal and supervisory framework for the *takāful* and *retakāful* sectors and governance of these industries at both national and international levels.

The IFSB and the World Bank wish to express their gratitude to the Undersecretariat of Treasury of the Republic of Turkey for supporting this conference, as well as to all the speakers and the discussants whose presentations have enriched the knowledge of all the participants and organisers and assisted them in understanding the industry better. The insightful sharing and exchanging of ideas among the participants, speakers and discussants were uplifting for all those involved in organising this conference. In this regard, the publication has also benefited from the review of Professor Habib Ahmed and a team of the IFSB and the World Bank Secretariat, headed by the IFSB’s Assistant Secretary-General, Zahid ur Rehman Khokher, and supported by IFSB Members of the Secretariat, Kartina Md Ariffin, Siham Ismail and Rosmawatie Abdul Halim, as well as the World Bank Global Islamic Finance Development Center in Istanbul headed by Dr. Zamir Iqbal, Lead Financial Sector Specialist, and supported by Fatih Kazan, Financial Sector Specialist and Mustafa Tasdemir, Financial Sector Specialist at Finance and Markets Global Practice of the World Bank.

Chapter 1, prepared by Serap O. Gonulal, presents an overview of the *takāful* industry, worldwide growth trends and policy developments in various regions. The author examines the prospects of the *takāful* industry and identifies initiatives in developing the sector. The roles played by the international standard setters such as the IFSB and AAOIFI in harmonising the regulatory frameworks between various jurisdictions are discussed in a positive light. The author identifies five key challenges: harnessing the governance and regulatory framework, improving risk management and internal controls, revisiting business models, transparency in surplus distribution, and developing human talents.

Chapter 2, prepared by James A. Smith, focuses on the evolving regulatory requirements of the global standard-setting institutions and their impact on the regulation of the industry. The chapter elaborates on the challenges faced by the regulators of *takāful* when regulation for the insurance sector is globalised. It also illuminates the industry players' perspective in meeting the changing regulatory landscape and the implications for their operations. In the aftermath of the Global Financial Crisis, *takāful* operators have faced new risk-sensitive capital requirements, and governance and risk management requirements, together with other prudential matters.

In Chapter 3, Dr. Alberto Brugnani highlights how *microtakāful* broadens the availability of risk coverage products to the wider sections of society. The author further emphasises the roles that various institutions, regulators and international organisations play in promoting financial inclusion through *microtakāful*. It is recognised that although financial inclusion is currently being promoted by majority insurers, there is still a segment of society that, for reasons of religious constraints, is not susceptible to the idea of insurance. The ability of *microtakāful* to penetrate this segment has seen the low-income population slowly opening up to the prospect of being protected, both from family and general *takāful* perspectives.

In Chapter 4, Zainal Abidin Mohd Kassim examines the various governance structures that have proven an effective way for jurisdictions to manage the risks in *takāful* operations. Key elements of risk management are shared to provide an enhanced understanding of how *takāful* operators are able to better equip themselves to manage the diverse risks. The author further asserts that *takāful* operators which compete with insurance on the basis of pricing are likely to fail, because the *takāful* business is conducted on a risk-sharing basis where the principal driver is not underwriting profits but service. Hence, managing risks for *takāful* should begin before the first product is sold, as different approaches to *takāful* result in different inherent risks. The author feels that, in order to achieve this objective, proper analysis should be done in screening appropriate investors as well as determining the *takāful* model that most benefits the main stakeholders, the participants.

Chapter 5, contributed by Dr. Ludwig Stiffl, draws upon the issues and challenges faced by the *retakāful* sector in meeting the demands of the *takāful* industry. The author uncovers the various problems faced by the *retakāful* industry, including the lack of clarity in contractual agreements, the involvement of profit commissions, uncertainty about the impact of the *wakālah* fee, and the fear of good cedants being pooled with bad cedants, which leads to the non-payment of surplus. The (lack of) regulation of *retakāful* activities has thus far created misinterpretation of various aspects of *retakāful* operations. This calls for the need to have a standardised supervising method of *retakāful* activities, in addition to replicating best practices by the industry players. This chapter also unveils a view of what the IFSB has recommended in its latest standard on *retakāful*, IFSB-18: *Guiding Principles for Retakāful (Islamic Reinsurance)*.

In Chapters 6 and 7, Professor Habib Ahmed summarises the key takeaways from the panel discussants and expresses his thoughts on the way forward for the *takāful* industry. It is envisioned that the *takāful* industry would have reached a level of maturity in the next 20 years where there would be a public policy towards risk allocation and management, where a legal infrastructure to mitigate risks and protect health is given the highest priority so that it can be provided by non-profits, markets and the government. In addition, the industry would have developed a balanced solution involving the family, non-profits, the market and the government in tackling longevity and intergenerational risks. The industry is also expected to have filled the gap of financial inclusion through *microtakāful*, with a revival of *zakah* and *waqf* as risk management institutions.

In the Opening and Welcoming remarks, Dr. Zamir Iqbal highlighted World Bank's engagement with Islamic finance and identified two key aspects with regards to the *takāful* sector from the World Bank's perspective. First, since insurance constitutes an integral component of a well-developed financial sector, sound growth of the *takāful* sector was critical to the development of the Islamic financial industry. Second, a developed *takāful* sector is also essential from a financial inclusion perspective. Ahmed Genc pointed out that similar to the global *takāful* industry which is relatively small, the *takāful* industry in Turkey is new but has a great potential to grow. Though the sector is growing in the country, there is a need for an enabling legal and regulatory environment. While highlighting that the growth of the *takāful* has been uneven in different countries, Jaseem Ahmed drew attention to the challenges that the *takāful* sector faces in realising its future growth potentials. Among others, he identified low returns on life/family products, weaker *retakāful* sector, and lack of adequate human capital and absence of the sound regulatory framework for the sector as constraints that can hinder the growth. Ramazan Ulger provided an overview of the Turkish participation sector detailing some of the features and figures related to the *takāful* sector. Though the current share of the *takāful* sector is small in the country, the recent trends indicate a high growth rate which is expected to continue in the future. Similarly, Ozgur Koc provided an historical overview of the origins of *takāful* in Turkey and the growth in the sector over time. He hoped that the legal and regulatory initiatives taken by the government would help the sector to grow further.

**Jaseem Ahmed**

*IFSB Secretary-General*

April 2017

**Dr. Zamir Iqbal**

*World Bank's Lead*

*Financial Sector Specialist*

*at the Finance and Markets*

*Global Practice*

April 2017



# ABOUT THE CONTRIBUTORS

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**Serap O. Gonulal** joined the World Bank in 2000 and is currently the Lead Insurance Specialist. Having a degree in Business Administration, Gonulal worked many years as high degree official in the Turkish Treasury Directorate of Insurance. She took a leading part in the development and establishment of General Directorate of Insurance, Turkish Catastrophe Pool in Turkey along with other reformative legislations for the Turkish insurance market. During her position in the Turkish Treasury, she joined to UK Insurance Supervisory Authority in 1990 and visited insurance sector for one and half years in London. She took part in OECD meetings many times to represent Turkish Treasury.

She joined World Bank in 2001 and is working actively at a global, regional and country level to enhance insurance regulation and supervision along with market practice. Her contributions in the field are advice-focused strategy, policy reform, regulation, insurance supervision, improvement risk management/transfer, insurance market practice. She is co-author of the book *Earthquake Insurance in Turkey* published by the World Bank Press (2006). In 2008, she contributed to the book, *“Protecting the Poor: A Micro Insurance Compendium”*, published by CGAP and the ILO. She has written numerous reports and papers on the subject of insurance regulation and supervision with the World Bank and is currently working on topics such as promoting the move towards risk based approach using Solvency II approach, Motor Third Party Liability Insurance to improve Road safety, Bank assurance to reach untapped populations. She worked as the editor of the books on, *“Alternative Approaches to Managing Risks”* and *“Motor Third Party Liability Insurance in Developing Countries- Raising Awareness and Improving Safety”* and *“Bank assurance”*. She participated in numerous Financial Sector Assessment Programme missions jointly with the International Monetary Fund. Her current work portfolio covers the countries: Bangladesh, Bhutan, Cambodia, China, Ethiopia, Myanmar, Nepal, Pakistan, Sri Lanka, Thailand and Vietnam.

**James A. Smith** studied in the UK at the University of Dundee, Scotland, and the University of Essex, before commencing his professional career in accountancy and business consultancy specialising in services to the insurance sector. He is a Fellow of the Institute of Chartered Accountants in England and Wales and a Senior Associate and Certified Insurance Professional of the Australian and New Zealand Institute of Insurance and Finance. Following extended periods of residence in Australia and Asia, he is now based in London, where he is a senior executive of a professional services firm.

Smith has been involved with international development activities in the financial services field, undertaking several professional assignments in countries such as Sri Lanka,

Pakistan, Indonesia, the Philippines and Uzbekistan, concerning insurance development and regulation. He has been closely involved in services to the insurance industry, often cross-border, relating to the new Solvency II regulatory framework and other aspects of insurance regulation, including business conduct, competition and contract requirements.

Smith's numerous consultancy assignments include work on projects funded by the World Bank, the Asian Development Bank and governmental agencies, considering means of expanding availability and reliability of insurance services. He has helped to develop and review regulatory frameworks for insurance, as well as advising industry players on matters of implementation and compliance. He served the IFSB as Consultant to the Working Group responsible for developing IFSB-18: *Guiding Principles for Retakāful (Islamic Reinsurance)*, which was issued in April 2016.

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**Dr. Alberto G. Brugnoli**, a former director with Merrill Lynch Bank, is an independent consultant on Islamic finance focusing on capacity building and structuring of Sharī'ah-compliant modes of financing. His unique professional background combines the Islamic, conventional and ethical finance sectors, while his practice aims at the creation of wealth through the full implementation of the social capital and territorial added value concepts. An innovative use of the financial mechanisms and structures applied to ethical monies allows for the emergence of new forms of governance that take into account the social, cultural and economic inclusion of all parts of society.

Dr. Brugnoli regularly chairs major Islamic finance forums worldwide and gives presentations in Arabic, English, French and Italian.

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**Zainal Abidin Mohd Kassim** is the Senior Partner at Actuarial Partners Consulting Sdn Bhd, Malaysia. He has been a consulting actuary with the company since 1982. His consulting experience spans the full spectrum of actuarial services, including: life, property and casualty (P&C) and health insurance consulting; family, P&C and health *takāful* consulting; retirement benefit consulting; social security consulting; and investment consulting.

Zainal Abidin's experience in *takāful* dates from 1985, when he was appointed as actuary to the first operator in Malaysia. He has extensive experience in the design and pricing of *takāful* products, including family, P&C and health *takāful*. He has written many articles and spoken at numerous conferences globally on his experience with the development of *takāful*. He has also been involved in strategic analysis and set-up of *takāful* and *retakāful* operators in Asia, Africa and Europe. As one of the first of the small number of actuaries



working in *takāful* and *retakāful*, Zainal Abidin has been at the forefront of the technical development of various *takāful* contracts and has interacted with many Sharī'ah scholars on the practice of *takāful*.

Zainal Abidin is a Fellow of the Institute of Actuaries of the UK, Fellow of the Actuarial Society of Malaysia and an Associate of the Society of Actuaries in the US, and is a past president of the Actuarial Society of Malaysia.

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**Dr. Ludwig Stiffl** obtained a Diploma in Business Administration in insurance and a certificate in Arabic from the University of Munich, followed by a doctoral thesis in Islamic studies. He has been working in reinsurance for 16 years and was the founding director of the *retakāful* operation of an international reinsurer. In addition to being a consultant for the World Bank and a member of a number of industry committees, he has published about a dozen scientific articles on *takāful* techniques and its *fiqh* foundations, and delivered several dozen papers and workshops at the leading *takāful* conferences. He is currently working on a second PhD on insurance sciences at Cologne University.

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**Peter Casey** is a consultant to the IFSB, and a member of the Legislative Committee of the Dubai Financial Services Authority (DFSA). He was previously the DFSA's Senior Director, Policy and Strategy, and Head of Islamic Finance.

Peter has been involved in standards development in Islamic finance through membership of the IFSB Technical Committee and several IFSB Working Groups, including those on Special Issues in Capital Adequacy, Governance of *Takāful* Operations, and Solvency Requirements for *Takāful* Operators. He has been a consultant to the IFSB on its standards on Supervisory Review Process and Core Principles for Islamic Finance, and is currently involved in projects on implementation of standards, *Retakāful*, deposit insurance and disclosure in capital markets. He participated in the joint IFSB-IAIS working group on *Takāful*, and in the IOSCO working group which analysed the application of IOSCO's Objectives and Principles of Securities Regulation to Islamic products. He has also been a member of the Islamic Finance Working Group of the Asian-Oceanian Standard-Setters Group. He has written two book chapters and numerous articles on Islamic finance topics.

Before joining the DFSA in 2002, Peter was Head of the Non-Life Insurance Department of the UK Financial Services Authority. Before that, he held senior regulatory posts in the Treasury, the Department of Trade and Industry and the Office of Fair Trading. He was educated at Cambridge University.

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**Habib Ahmed** has an M.A. (Economics) from the University of Chittagong, Bangladesh, a Cand.oecon. from the University of Oslo, Norway, and a PhD (Economics) from the University of Connecticut, in the US. Before joining Durham University as Professor and Sharjah Chair in Islamic Finance in 2008, Ahmed was Manager, Research & Development, Islamic Banking Development Group, the National Commercial Bank (NCB), Kingdom of Saudi Arabia, and worked at the Islamic Research & Training Institute of the Islamic Development Bank Group, Saudi Arabia. He has carried out numerous consultancy assignments with institutions such as the Islamic Development Bank, COMCEC, CIBAFI, the IFSB and the World Bank.

He has also taught at the University of Connecticut, the National University of Singapore and the University of Bahrain. He was a member of the Capital Adequacy Working Group of the IFSB. Ahmed has authored/edited more than 85 papers and publications, which include articles in international refereed journals, books, chapters in books, and other academic papers/monographs/reports. Some topics of his research include Islamic microfinance, risk management and corporate governance in Islamic financial institutions, and the implications of Islamic law for economic institutions and organisations. A recent book, *Product Development in Islamic Banks*, was published by Edinburgh University Press. Ahmed's recent research interests include contemporary applications of Islamic commercial law, inclusive Islamic finance, legal and regulatory issues in Islamic banking and finance, and the integration of *waqf* and the financial sector.

# OPENING AND WELCOMING REMARKS<sup>1</sup>

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## Dr. Zamir Iqbal<sup>2</sup>

It is my pleasure to welcome you, on behalf of the World Bank, to this event. I am thankful to the Islamic Financial Services Board (IFSB) and Secretary-General Jaseem Ahmed for conceiving this idea of collaborating on *takāful* in Istanbul. I am also thankful to the Turkish Treasury for being our partner and giving us their full support. Thanks also to the Insurance Association of Turkey and the Participation Insurance Association in Turkey for their partnership.

The World Bank's engagement with Islamic finance goes back many years. Our interest in Islamic finance in general and *takāful* in particular, can be viewed from two angles. First, we view *takāful* and insurance as integral components of a well-developed financial sector. Many studies and research have shown that a well-developed financial sector contributes to economic development. In countries that have Islamic finance, Islamic banking and Islamic capital markets are growing and there is a need for insurance to complement these services. This implies that the insurance sector should become an integral part of a well-developed financial sector. Therefore, the World Bank supports to promote the *takāful* sector in countries in which Islamic finance has grown.

The development of the *takāful* industry is critical to the development of the ecosystem required for the overall development of the industry. Once there is an ecosystem of Islamic finance, we can look at its potentials and benefits which include risk sharing, economic development and other features.

A second way to look at *takāful* is from the perspectives of financial inclusion and financial deepening. The World Bank and its President, Dr. Jim Yong Kim, have an initiative and goal called "Universal Access to Finance (UAF)". Unless there is access to finance and financial services for every adult citizen, it is difficult to achieve the goals of economic development and to share prosperity.

Over a billion adults globally do not have any form of financial access. The World Bank gives a high priority to establishing an enabling environment to promote financial access. Within this theme, we realise that Islamic finance could play a vital role in enhancing such access. Apart from being an alternative financial system, there are individuals who prefer Islamic finance due to their religious beliefs. If we are able to make Islamic financial services

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1 Speeches were delivered during the opening and keynote session of the conference on 31 May 2016.

2 Head, World Bank Global Islamic Finance Development Center, Istanbul, Finance and Markets Global Practice, World Bank.

available to them, they will become a part of the financial system, which will ultimately lead to enhanced access. So from this angle, we consider *takāful* an important tool for promoting financial access and financial deepening anywhere in the world. In general, insurance penetration in Muslim countries is very low and within that, the *takāful* penetration is even smaller. Thus, it is critical that we pay attention to this sector and endeavour to enhance and develop it in order to provide better financial access.

During 2015, under the Turkey's presidency of the G20, Islamic finance was discussed at the G20 platform, resulting in a Joint Note by the World Bank and the IMF that called for integration of Islamic finance with the global financial system. One of the recommendations of the note was that both the national and international authorities work more closely with the standard-setting bodies such as the IFSB. The regulators need to cooperate to ensure that there is an enabling environment and a well-developed ecosystem for Islamic finance. This was a good endorsement for the Islamic financial industry. Now it up to us – the stakeholders, multilaterals, standard-setting bodies and regulators – to take that road map and go to the next level to develop this industry so that we can benefit from its potential. I welcome you again, and I hope that you enjoy the discussions over the next two days.

## **Ahmed Genc<sup>3</sup>**

I would like to express my pleasure at being here on the occasion of this international conference on *takāful*. Let me first extend a warm welcome to our distinguished speakers and guests. You have come from far away to share with us your experience and knowledge at this conference. I wish to congratulate the World Bank and the IFSB for jointly organising this important event. I wish to thank also the Insurance Association of Turkey and the Participation Insurance Association for their support.

The conference will focus on realising the value proposition of the *takāful* industry for a stable and inclusive financial system. We hope that it will serve not only as a useful complement to a better understanding of these issues, but also contribute to a wider cross-border engagement in stability issues in *takāful*.

When we look at the Islamic financial system, which was introduced more than 40 years ago, we see that Islamic banking today constitutes the backbone of the system. In the last two decades, Islamic finance has grown very rapidly across the world. During this period, Islamic financial instruments also became more diversified. The global Islamic finance services industry reached an overall total value of USD 1.9 trillion as of 2015 and currently represents approximately 1% of global assets.

Compared to the Islamic banking industry, *takāful* – or the Islamic insurance industry – is relatively new. However, *takāful* has an important role in financial inclusion. The global gross contribution size of the *takāful* industry has reached USD 23 billion, up from only USD 5 billion a decade ago. It remains significantly small in size compared to the global Islamic financial assets, with a market share of only 1%. However, as it has high growth rates, it has the potential to be an important and integral part of the financial system. So, there is a long way to go for the *takāful* sector. The Islamic insurance industry has become a developing area of interest worldwide for entrepreneurs, regulators and policymakers.

With a history dating back to the 1980s, Islamic finance has grown remarkably in Turkey. A shift in the government's priorities has allowed Islamic finance to gradually acquire legitimacy in Turkey. In particular, developments in the legal and regulatory frameworks demonstrate the country's commitment to Islamic finance. Particularly in the last decade, the Islamic financial system, an alternative to the conventional financial system, has gained significant support, and the Islamic banking and *takāful* sectors have developed rapidly. A number of Islamic financial institutions are offering quite a wide range of products in Turkey.

In Turkey, we call our banking and insurance sectors operating on an Islamic basis “participation banking” and “participation insurance”. We use this terminology as we think that the risk-sharing aspect of this system, in particular, relies on the participants’ and stakeholders’ involvement in the risk. Besides, the participation banking and insurance sectors are not only for Muslims, due to their explicit ethical and profitable structures. In other words, these sectors are providing products and services that appeal to all clients, whether they are Muslims or not.

The Turkish participation banking sector dates back to the mid-1980s, since which time the sector has enhanced its significance in the Turkish financial system by recording high growth rates. Currently, we have six participation banks. The Turkish participation banking sector has grown faster than most of its international counterparts. In terms of fund sizes, participation banks in Turkey currently account for 6% of the total banking sector and represent nearly 3% of the global Islamic banking assets. Finally, in 2015, one Turkish participation bank launched Germany’s first full-fledged Islamic bank as the first step in offering Shari’ah-compliant retail banking services across the continent.

I would like to stress that *takāful* has become an indispensable and complementary element of the Islamic financial system. *Takāful* plays an important role in including people who wish to take out insurance through an insurance sector that accords with their beliefs. The *takāful* sector has been developing in Turkey over the last five years. Currently, there is no legal obstacle to *takāful* business in Turkey. The Turkish jurisdiction does not oblige insurers to adopt any specific *takāful* model, such as a separate company model or a window model. For instance, two of the seven insurance companies in the *takāful* sector in Turkey operate as separate companies, while the other five have adopted the window model.

Total general contributions are about USD 1 billion, and the *takāful* sector represents (in 2015) only 2.7% of the total insurance sector. The current small size of the *takāful* sector in Turkey demonstrates that there is still a long way to go.

As you can see, the scope of Turkey’s Islamic finance market is widening. The growing presence of Islamic banking and *takāful* needs to be accompanied by the development of effective regulation and supervision. We believe that growth of the sector will be beneficial for both private- and public-sector participants. Finally, I would like to express my view on another aspect of finance in general and Islamic finance in particular. We need more and more Islamic finance products, and in this context we need innovation. So, in my humble opinion, innovation should be the key for us.

## **Jaseem Ahmed<sup>4</sup>**

It is a great pleasure to welcome you all to this conference, which is jointly organised by the IFSB, the World Bank and the Treasury of the Republic of Turkey. It is also a pleasure to be here in Istanbul once again, where a few years ago, in 2012, we held the 9th IFSB Global Summit, which was hosted by the Central Bank of the Republic of Turkey.

The *Takāful* Conference marks a further milestone in the IFSB's partnerships with both the World Bank and with Turkey. Our collaboration with the World Bank goes back a number of years and has been fruitful in terms of bringing new insights to key issues in Islamic finance. An earlier collaboration led to a joint publication on insolvency, a subject that is becoming increasingly important in the aftermath of the crisis resolution lessons that have been drawn from the Global Financial Crisis.

We plan similarly to publish the key articles and discussions arising from this conference.

The IFSB has also a deepening partnership with Turkey in which the Central Bank of the Republic of Turkey (CBRT), Banking Regulation and Supervision Agency (BRSA) and Central Market Board of Turkey (CMBT) are all Full Members of the IFSB\*. Each of these institutions plays an important role within the IFSB, and we have benefited greatly from their individual as well as collective contributions, most recently in the productive way that they have advocated for Islamic finance in the G20 platform.

It is highly relevant that the Islamic finance sector looms large in the economic goals of the government of Turkey. There has been significant progress in terms of integrating Islamic finance into public expenditure through the launching of a sovereign *sukūk* programme, and plans are under way for the development of Sharī'ah-compliant capital markets that can help to mobilise funding for infrastructure and other developmental expenditures.

The Treasury has, of course, played a key role in the coordination of these plans, as well as in their implementation. It also has specific responsibility for the *takāful* sector. We are therefore delighted to join the Treasury in jointly conducting this conference.

The conference is an important opportunity to address some of the key challenges facing the *takāful* industry. I will not try to anticipate the deliberations that will take place here today and tomorrow, but allow me to highlight a number of the issues that I believe may be relevant and will perhaps feature in your discussions.

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<sup>4</sup> Secretary-General, Islamic Financial Services Board

\* The Treasury of the Republic of Turkey became Associate Member of the IFSB in 2016.

One issue is that the industry remains small despite rapid growth recently and, furthermore, that it is concentrated. Only three jurisdictions account for 84% of the global *takāful* contributions: Saudi Arabia (37%), Iran (34%) and Malaysia (14%). The expansion in the number of *takāful* operators has also stagnated; towards the earlier years of this decade, we celebrated the establishment of the 200th *takāful* operator globally, the number today has not changed much, as there are an estimated 205 operators globally. So, what are the factors that are contributing to this scenario in the global *takāful* industry? I look forward to your insights.

In the meantime, allow me to observe that, from a life insurance or family *takāful* perspective, in an era of low interest rates and volatile financial markets, there are significant downside implications for the returns generated by the life/family products offered by the operators.

Given that insurance and *takāful* operators invest heavily in financial market instruments to generate returns for policyholders, the state of the financial system directly affects these returns. In addition, key *takāful* markets operate in emerging economies, which in the recent past have been exposed to sell-offs during bouts of financial market volatility.

An additional factor, which I expect will feature in your discussions, is that of *retakāful* operations; that is, the ability to provide protection for higher-value risks also depends on the strength of the *retakāful* sector, apart from other organisational structural capacity and resources factors. Generally, *takāful* operators in most jurisdictions have very limited financial resources as compared with long-standing international insurance groups; as such, *retakāful* avenues are pertinent to support further growth as well as to safeguard their balance sheets and gain capacity. Here, there are two critical considerations:

1. It has been observed that the shortage and competitiveness of *retakāful* coverage is possibly leading to a leakage to the conventional reinsurance market, causing a major constraint on the growth of *retakāful*.
2. Another issue is the key constraint in terms of lack of specialised human capital and the need for more research and development to develop products.

Collectively, these issues act as a constraint on product innovation, which is necessary for the industry to progress further. The main contributors to *takāful* operators' income are family, medical and motor *takāful*, which consist of mainly "plain vanilla" products designed to provide basic protection for households.

Finally, in terms of the issues that I propose to highlight, there is the issue of the regulatory framework for the *takāful* industry. The global insurance industry has undergone major



regulatory reforms since the Global Financial Crisis with a view to achieving better stability and resilience. In this regard, Solvency II is an example of an EU legislative programme expected to be implemented in all 28 Member States, including the UK, this year. Solvency II is a comprehensive programme of regulatory requirements for insurers, covering strengthened capital requirements, authorisation, corporate governance, supervisory reporting, public disclosure and risk assessment and management, as well as solvency and reserving.

There have been important regulatory changes over the last couple of years in *takāful* markets, such as enhanced liquid asset requirements in Kuwait and a new solvency regime in Bahrain.

A significant structural shift is under way in Malaysia, where the recently implemented *Islamic Financial Services Act 2013* enforces separation of licences between the general and family *takāful* businesses and gives a time period of five years starting 30 June 2013 for existing composite *takāful* operators to separate the two businesses into different entities. This measure is expected to allow regulators to better assess prudential risks, given the different complexities and risk profiles of the respective products.

Turning to the IFSB, we began to issue our *Guiding Principles for the Takāful Sector* in 2009, following a joint study with the International Association of Insurance Supervisors. Our objective is to provide a comprehensive range of standards or guiding principles covering the banking, *takāful* and capital markets sectors.

Since our first standard, the *takāful* sector has received increasing attention from the IFSB. Specifically, the IFSB has four dedicated standards: IFSB-8 on governance for *takāful*; IFSB-11 on solvency requirements for *takāful*; IFSB-14 on risk management for *takāful*; and, most recently, IFSB-18 on guiding principles for *retakāful*.

In terms of our future work programme, we envisage the launching of three standards during the next three years, within the framework developed under our SPP 2016–2018, including a standard on core principles in *takāful*, which we expect to launch in 2018.

The expansion of the *takāful* market is a necessary step to support the risk management of assets and savings/protection of individuals in the real economy. The potential for the *takāful* sector is promising given that large segments of the insurance market in key Islamic finance jurisdictions remain untapped and mainly dominated by conventional insurance providers.

The global *takāful* sector thus has considerable market opportunities, supported by both demand and supply dynamics across the various markets offering Islamic financial services.

Nonetheless, the industry faces several internal challenges that require efforts by the industry stakeholders, working in collaboration, to mitigate them. It is these challenges that I expect you to address during this conference.

I look forward to the various sessions. We are fortunate to have very able speakers and panellists at this conference who are here with us to discuss important and relevant aspects of the *takāful* sector and its stability and resilience.

I would like to end my remarks by once again thanking the World Bank and the Turkish Treasury for co-organising this event with the IFSB. On that note, I wish you very productive deliberations and discussions in what follows.

# KEYNOTE ADDRESSES

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## **Ramazan Ulger<sup>5</sup>**

I welcome all participants to this meeting in Istanbul. The topic of the event is both interesting and important for us. In the Turkish insurance market, Islamic insurance – or “participation insurance” – is not very well developed. While it is a new industry, we feel it has very strong potential, since a very important segment of the population is being left out of insurance. Events such as the current one point us in a direction and provide us with ideas to strengthen the industry by establishing appropriate infrastructures.

A review of the Turkish insurance market today gives an idea of the share of Islamic insurance and the development capacity of insurance within the Turkish economy. Our legislation requires that life insurance and non-life insurance companies operate as separate companies. Of the total of 61 insurance companies in Turkey, 19 are life and pension companies, 4 are life companies, 37 are non-life companies and 1 is a reinsurance company. While around 20,000 people work in these companies, more than 75,000 people, including expert brokers, work directly in the insurance distribution business.

The Turkish insurance market is integrated into the international system, as international companies account for 72% of the issued capital of the Turkish insurance market. Almost all of the major companies that operate in the world operate in Turkey. This shows not only the international nature of the industry but also the strength of the market. The total premium collected by the Turkish insurance market in 2015 was TL 31 billion, of which life premiums totalled TL 4 billion and non-life premiums TL 27 billion. These figures indicate that while life insurance is relatively undeveloped in Turkey, the non-life insurance market is more developed. Furthermore, life insurance is also limited with credit-linked insurers. The contribution of the insurance sector to the financial system is very important. Today, the total amount of the guarantees given by the insurance sector is TL 77 trillion, which is 44 times our gross domestic product (GDP). The individual pension sector is growing as a long-term saving scheme. The legal infrastructure for the private pension system was developed in 2003 and became operational the same year. Even though it is a relatively new system, 6.2 million people currently have individual pension contracts. There is now a new plan, called “automatic participation”, which intends to include every employee in the private pension system. This plan is expected to cover 13 million individuals once the law is passed.

As of April 2016, the total fund balance of the private pension system was TL 53 billion, of which approximately TL 6 billion is transferred from public sources as state support. In our

private pension system, the state's contribution is limited to 25% of the minimum wage for people with contracts. That is, everyone who has a private pension contract makes use of the state contribution. The state has direct support in this fund management and fund accumulation system. Again, if you look at the size of the insurance market, insurance companies were valued at TL 96 billion as of 2015. The sum of the resources accumulated in total companies by these insurance funds is an indication of the importance Turkey places on the creation of long-term domestic resources in the economy. Of this TL 85 billion, TL 37 billion is invested in public debt instruments. We want to increase the amount of these insurance resources and funds, in order to direct them to long-term investment.

The paid-up shareholders' equity of insurance companies in Turkey is approximately TL 12.4 billion and has been growing steadily over the years. In 2015, Turkey faced a problem of unprofitability in non-life insurance. We think that this problem will be resolved after 2016. While life and pension companies reported a total year-end profit of TL 569 million in 2015, non-life companies reported a loss of TL 418 million. If we look at the development over the years, we see that there are few problems in the life companies. However, in non-life companies we see that there is irregularity in their profits when compared with their equity. Regulatory arrangements have been made to attempt to solve this problem. We expect that, in the years ahead, the insurance market will achieve stability in terms of profitability, as appropriate infrastructures have been established in this direction.

In general terms, Turkey has a strong capital structure, competent human resources, and know-how from international capital. Further, in a growing country like Turkey, there are big investments, such as the third airport, bridges and energy companies. Turkish banks can finance all of these investments, and Turkish companies can handle insurance for them. In fact, this is one of the country's strengths. In addition, regulations specific to Turkey have been passed in regard to issues that are a problem not just here but in the world more generally, such as earthquake insurance and agriculture insurance, which are areas of interest to a large part of society yet the rate of insurance coverage is very low. Since legislation has been developed, these sectors have reached a considerable proportion of insurance rates.

The Turkish insurance sector shows great potential promise. The sector is growing very quickly, with growth rates in recent years higher than the country's GDP. Specifically, the insurance market grew at twice the rate of growth of the country's output. Despite this, the size of the insurance market in Turkey is small, and not in proportion to other developed economies. The potential for us lies here. If we look at 2010–15, the insurance market in Turkey increased by around 16% on average, compared to 5% growth of the country's GDP. Despite this, penetration is very low. There is therefore huge potential for growth, given the difference between the size of the insurance sector and the economic magnitude of the country.

Turkey is the world's 18th-largest economy, with a GDP of USD 800 billion; however, in terms of insurance penetration or insurance production, it ranks 39th. In other words, there is a disparity between the country's GDP and the size of its insurance sector, with an important segment that is not in insurance or not in cooperation with insurance. In fact, it is hoped that this conference will help to provide some answers to why that is the case. We believe that the potential for participatory insurance will grow with the spread of Islamic finance. Currently, insurance is perceived more as a European or Western idea. However, insurance is necessary for individuals as well as for the financial system as a whole. Turkey has a population of 78 million, 72% of whom live in cities. The high rate of urbanisation (the global figure is 52%) is combined with the fact that the population is moving away from traditional life, which was based around extended families, and towards core families. This weakening social solidarity in families has created reliance upon individual solutions in times of financial hardship, which is where insurance steps in.

In addition, investments in infrastructure along with compulsory insurance, health insurance and other segments are continuing and their integration into the financial system will be ensured. This is an important opportunity for Turkey, where 65% of the population is under 40 years of age. In fact, it is this segment that most needs insurance. A very important segment, still young, has just entered business. As these people age, they will need more savings and more assurance. And in a modern society, one means of providing this is the insurance industry. On the other hand, the current (in 2015) rate of penetration is 1.6% of GDP, compared with the world average of 6%, indicating that the capacity is underutilised.

The global average for per-capita insurance premium payments is USD 660; for Europe it is USD 1,900 and for Asia it is USD 307, whereas for Turkey it is USD 153. When we look at Turkey's speed of development and change, the speed of urbanisation, and the speed of conversion to an individual family structure, the insurance sector has to grow to bridge the gap. But while the sector is growing, the infrastructure needs to be established so that it can cover the whole society.

Turkey's economic indicators show that there is a current account deficit of 4.5% and a low savings rate of 13.6%. To increase this savings rate, support has been given to private pension systems, as mentioned previously. Current credit-deposit ratios indicate that not all of the loans used in the country are covered by internal sources. Some are covered from outside – for example, by insurance. Because of long-term resource pooling, higher growth of insurance funds in the country can potentially lower this ratio.

We would like to emphasise the importance of *takāful* in Turkey. Since systems such as the current account deficit, credit-deposit ratio, individual pension system and automatic participation are developing, they need to be supported by *takāful* for that part of society

that is not in the insurance system. In the banking sector, participation banking has a share of only 3.5% currently, but participation banks have set 15% of market share as their target.

The share of participation insurance is 2% of total insurance premiums. Companies operating in conventional insurance and life pension companies are not usually separate companies in Turkey; currently, companies do participation insurance through a window operation. In other words, a company that works in all branches of the insurance business continues its activities by opening up a department to manage participation insurance. For this purpose, we must continue to work to develop an interest-free finance and insurance system among alternative financial instruments. Because participation insurance has an important potential, it has a rising trend. In other words, our expectation is that participation insurance will grow at a faster rate than conventional insurance. Again, if we look at the share of participation insurance in individual pension system funds, it was around 4% at the end of 2015 and the total amount was around TL 1.9 billion. This ratio increased to 4.15% and amounted to TL 2.2 billion as of May 2016. We expect that the growth rate I mentioned earlier will be even faster than that of the other traditional insurance fund-raising systems.

We consider participation insurance, which is a separate part of Islamic finance, to be a part of banking. Therefore, we want to draw attention to participation banking. There are currently six participation banks in Turkey, one of which is in the process of obtaining a licence. We think that the faster these participation banks grow, the faster will be the growth of participation insurance. I mentioned earlier that the target share of participation banking in the financial banking system is 15%. This will also be accompanied by an increase in the proportion of participation insurance in the overall insurance industry. Turkey's geographical position, stable growth and dynamic structure are all very promising. We are a regional centre in terms of finance, and major infrastructure investments are continuing. Through meetings such as this conference, Turkey's presence, and the strength and capacity of its infrastructure, will become better known. In this regard, both our integration with the international system and our legal infrastructure will develop. I think that, along with that development, the necessary arrangements will be put in place for the development of the *takāful* sector.

## **Ozgur Koc<sup>6</sup>**

Welcome, everyone. Some other speakers have discussed how *takāful* originated in Turkey. I want to add a brief statement about how *takāful* started and about the current situation in Turkey. The idea to establish a *takāful* company in Turkey came from our shareholders in 2004. Prior to that time, there was no Islamic bank in Turkey. Instead, there were four financial institutions that were called “finance houses”. An insurance company could not invest to get interest-free investment returns in Islamic banking. After 2004, these finance houses were transformed into Islamic banks, which made it possible for insurance companies to get interest-free investment returns. This was the first important milestone in establishing a *takāful* company in Turkey. Our group explored the feasibility in 2008 and the first non-life *takāful* insurance company was established in 2009.

When people asked me at that time how *takāful* companies would operate in Turkey, I told them it would not be easy; the road would be long and narrow. Now, seven years after our establishment, we have an association and we have many guests at this conference who are eager to discuss *takāful* business in Turkey. So, I think the road is getting shorter now. But still we have many things to do. First, we don’t have any laws regulating participation insurance in Turkey. We need some stipulations in the insurance law for identifying *takāful*. We also hope that the government will take the initiative to establish and regulate a *takāful* system in Turkey.

As Ramazan Ulger stated, the participation finance system is important in Turkey. We had four participation banks, which number will soon become seven. The total market share of these banks is around 5–6%. The total participation insurance market share is about 2.3–2.5%, with a very heavy dependence on the Islamic banking system. When we look at the environment for a participation insurance association, we see a great opportunity in Turkey to develop a participation insurance system. Government initiatives are also very important. Being a member of the free trade and finance world, we are meeting regularly to establish an Islamic financial centre under the financial centre in Istanbul in order to develop the system further. This will provide an important growth potential for the banking, capital markets and *takāful* sectors of the financial industry.

I would like to thank all those who are participating in this important conference. As *takāful* operators in Turkey, we have too much to do in the future, but we are very hopeful and optimistic about the potential here. There is a good and strong shareholding system in Turkey, along with good know-how and technology, especially in the insurance industry. All these aspects will help the *takāful* system to develop in Turkey.

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6 President, Association of Participation Insurance, Turkey





# INTRODUCTION

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## ***Takāful*: Basic Concepts and Principles**

One of the key functions of the financial system is to manage and mitigate risks by “facilitating the trading, hedging, diversifying and pooling of risk” (Levine, 1997). Conceptually, the broad perspective on risk and its management are embodied in the overall goals of Islamic law, or *maqāṣid al-Sharīʿah*. Ghazali defines *maqāṣid* as promotion of “the well-being of the people, which lies in safeguarding their faith (*dīn*), their self (*nafs*), their intellect (*‘aql*), their posterity (*nasl*), and their wealth (*māl*)” (Chapra, 2008). The principle of *maqāṣid* would imply taking all precautions to safeguard present and future wealth and progeny.

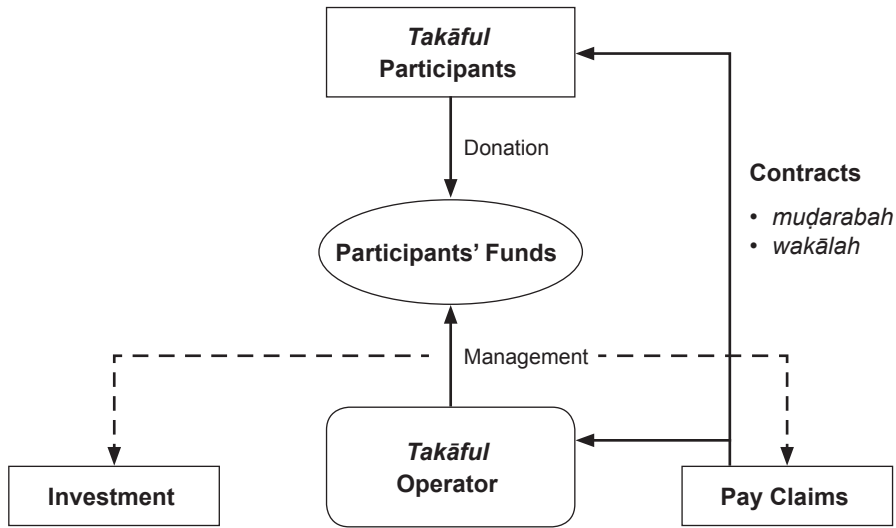
Siddiqi (2009) discusses the approaches to risk management in financial intermediation from an Islamic perspective. He identifies two broad approaches of managing risks: sharing and transferring. While the tendency in conventional finance is to transfer risks, he asserts that the approach in Islamic finance should be risk sharing. This is because selling/buying of risks is akin to gambling and is thus prohibited in Islam. Thus, from the Islamic perspective, risk management mechanisms focus on risk sharing rather than risk transfer. Although risks cannot be hedged by selling/transferring unbundled or independent risks, they can be transferred along with the underlying asset.

In the conventional financial sector, the key risk management functions are performed by the insurance sector. However, the Islamic Fiqh Academy declared conventional insurance to be prohibited in Resolution No. 9 (9/2) and proposed using cooperative insurance based on charitable donations (*tabarruʿ*) and cooperation or mutual help (*taʿāwun*) (IRTI and IFA, 2000: 13). Specifically, conventional insurance companies are deemed to engage in *ribā* (interest-based transactions), *gharār* (excessive uncertainty) and *maysir* (gambling), which are prohibited by Sharīʿah. As a result, various models of *takāful* (mutual guarantee) are developed for use by Sharīʿah-compliant cooperative insurance schemes.

The key organisational feature of the *takāful* model is mutual insurance, whereby participants (i.e. policyholders) own the risk pool and the managerial function is performed by a *takāful* operator (TO). The basic structure of the *takāful* model is shown in Figure 1. Depending on the relationship between the *takāful* participants and the TO and nature of the participants’ risk fund, two key models of *takāful* can be identified. The first is a *muḍarabah* (partnership) model in which the TO and the participants have a partnership relationship. The participants contribute funds (*tabarruʿ*) to the participants’ risk fund, which is managed by the TO. The TO invests the funds in income-generating activities and takes a share of the profits. After meeting the claims of the participants, the surplus is distributed among the participants. A *wakālah* (agency) model is very similar to a *muḍarabah* model, except that the TO acts as

an agent, instead of a partner. As such, the TO is paid management fees as compensation instead of profit. Note that *takāful* can include features of both *muḍārabah* and *wakālah* contracts.

**Figure 1: The Basic Structure of *Takāful* Models**



Source: Adapted from Ali and Odierno (2008: 33).

The policies offered to Muslim communities carry with them the additional religious obligation of getting rid of the three prohibited elements featured by their conventional counterparts as identified above. Specifically, *takāful* operators would also take the following steps to ensure Sharī'ah compliance.

- (i) The uncertainty (*gharār*) that is present in any form of contract that is lopsided in favour of one party at the expense of the other. In the case of the conventional insurance contract, payment amounts and timing are uncertain; and this uncertainty is offset in *takāful* by the intention of mutual assistance among the participants in the pool.
- (ii) The charging of interest (*ribā*), which is removed by the adherence to Islamic finance principles in managing assets. In conventional life insurance products, an element of interest exists as the insured, on his or her death, is entitled to receive much more than he or she has paid.
- (iii) The gambling (*maysir*) that occurs when the participant contributes a small amount of premium in hope of gaining a large sum; or when the participant loses the money paid for the premium when the insured event does not occur; or when the insurer itself will be in deficit if claims are higher than contributions. In *takāful*, this

element is removed by separating the shareholders' and participants' funds, with the latter removing emphasis on profiting and focusing on protection against risks.

The implementation of these obligations may be straightforward for entities that are formally regulated, whereas for less regulated or unregulated entities a robust operational, screening and review governance framework is needed. In both cases, a strong and independent Sharī'ah board with adequate capability to exercise objective judgement on Sharī'ah-related matters, and well-defined operating procedures and lines of reporting, is required.

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# CHAPTER 1: GLOBAL OVERVIEW OF THE *TAKĀFUL* SECTOR: TRENDS AND POLICY DEVELOPMENTS

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**Serap O. Gonulal**

## **Introduction**

*Takāful* is the Islamic counterpart of conventional insurance, and exists in either life (or “family”) and general forms. It is based on concepts of mutual solidarity, and a typical *takāful* undertaking will consist of a two-tier structure that is a hybrid of a mutual and a commercial form of company. As all the functions of a *takāful* undertaking should conform fully to Islamic law (Sharī’ah), it has implications in the areas of regulation and supervision and can raise significant issues.<sup>7</sup>

The joint stock model and the mutual or cooperative model have been the traditional ways of delivering insurance. The *takāful* model has now emerged as the third leading structure and, unlike the early mutual model; it was born into a world driven by legislation that contains onerous capital requirements designed to ensure that the insurer meets its obligations to the insured. Thus, the evolution of *takāful* has been affected by the regulations within which it operates. *Takāful* presents an alternative way of providing insurance. This will increase the choice available for consumers. In order for *takāful* to succeed, its implementation must be on a holistic basis, and, in particular, its legal framework must cater to its unique features.

Sustained growth over the longer term, and an extension of *takāful* beyond the Muslim countries, will require the key issues to be addressed. First, product development and design is the most important issue to be focused on, even in the advanced markets; second, in order to develop truly global risk-sharing tools, there may be a need for standardisation in terms of business models, market practice and legal/regulatory environment. This needs a particular focus on the multicultural populations of Muslims and non-Muslims. The key to the success of a risk-sharing mechanism such as *takāful* is to have developed Islamic financial markets with a broad range of investment opportunities and adequate depth. It is striking that, while Muslims account for a quarter of the world’s population, they have a low degree of insurance penetration. One particular reason for this, among many, is the limited access to the benefits of insurance, as there is insufficient awareness of the availability of Sharī’ah-compliant insurance in the form of *takāful* and/or Islamic insurance.

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7 Islamic Financial Services Board and International Association of Insurance Supervisors (2006), *Takāful* (Issues Paper).

Historically, resemblances can be observed in a *takāful* system that bear the same spirit as was present in the early cooperative movements that took shape in Europe and in the Americas in the 1800s. A basic analysis of these movements will show that they had similar characteristics and the same fundamental values – that is, promoting voluntary association, enhancing inclusion, ensuring accountability for strategic decisions, and supporting the communities that they serve.

The global insurance market had a fair growth rate in 2014, with considerable variation across regions and countries. In that year, global real premium growth rates were realised at 2.9% in the advanced economies and 7.4% in the emerging and developing countries.<sup>8</sup> While both global life and non-life insurance growth rates were slower in the post-crisis era compared to the pre-crisis years, stagnation in life insurance seemed to be more pronounced in the latter period. Similar to the rebound in the insurance sector globally in 2014, the global *takāful* industry also had better growth with respect to contributions in 2014 compared to 2013, historically its lowest level. Indeed, the growth rate of gross contributions fell to low single digits (2.8%) in 2013 and then bounced back to 15.5%, close to the 2009–13 growth rate average.<sup>9</sup>

The definition of what exactly is a *takāful* operation still needs to be clarified. This does not mean that there is any doubt about the development of the *takāful* industry over the 40 years or so since the first “*takāful*” company made its appearance; rather, what constitutes a *takāful* operation can vary significantly from one country to another. So, we can talk about a relative phenomenon here which leads us to focus more on particular cases, rather than jumping to general conclusions which could be misleading.

Overall, gross contribution growth rates were positive in both the conventional and *takāful* sectors, with significant variation over the regions in 2014. In the Gulf Cooperation Council (GCC) region, both the conventional and *takāful* sectors had positive growth rates of nearly 15%, although *takāful* outgrew its conventional counterpart. On the other hand, growth of the *takāful* industry was astounding in the East Asia and Pacific (EAP) region compared to the conventional segment. In 2014, *takāful* grew at 19.4% in this region, the highest growth rate globally, thanks to a figure of over 25% in Malaysia, while growth in the conventional segment remained at 0.7% during that year. Similar to the Eastern Pacific (EPAC) region, growth of *takāful* far outpaced conventional insurance in North Africa. In spite of the fact that the *takāful* industry kept pace with its conventional counterpart in Algeria, it is the ten-fold growth performance of the *takāful* sector compared to the conventional sector in Egypt (22.4% in *takāful* and 2.2% in conventional insurance) that accounted for the robust growth in *takāful* in North Africa. Conventional segments outperformed the *takāful* sector only in

8 Swiss Re (2015), *Sigma-World Insurance in 2014: Back to Life*.

9 Islamic Financial Services Industry Stability Report 2016 (IFSSR 2016).

the South Asia (SA) region in 2014, although to a limited extent. As regards other regions, in 2014, the conventional sector contracted in the Levant, while the *takāful* sector grew by around 12.8%. This is mostly due to contraction of the conventional sector in Turkey (in both nominal and USD terms).<sup>10</sup>

Although the global *takāful* industry became a massive USD 23.2 billion market in 2015,<sup>11</sup> there are still critical gaps that need to be addressed by industry practitioners and experts. Cooperation with governments is essential in this process. So, what are the terms and conditions needed in order to work and cooperate in this environment? There is surely a potential market for the risk-sharing approach if a suitable business model, with principles that can work in different environments, could be created for *takāful*. That is probably the starting point if the primary aim is to reach untapped populations around the world and increase the penetration ratio globally.

It is expected that the demand for *takāful* will continue to grow vigorously. It has a very important role to play in providing economic stability and in empowering individuals across many nations. Regulators and market practitioners have a key role to play in this respect by providing supportive regulatory frameworks and effective market practice. The encouragement of capital providers to invest in *takāful* structures in this sense will accelerate and embolden the businesses, thus increasing participants'/contributors' confidence in using *takāful* products.

This chapter sheds light on specific *takāful*/Islamic insurance approaches and provides an overview of the drivers of the global movement, its successes, and the challenges it faces in reaching untapped populations globally.

## **The Need for Insurance/*Takāful*/Islamic Insurance<sup>12</sup>**

Human life is filled with uncertainty. How is it possible for humanity to reduce the effects of uncertainty? This quest for certainty led to the creation of the concept of insurance, with its built-in fundamental safety net: in return for a premium, an insurance policy pays out a specified sum assured on the occurrence of a contingent event. How this arrangement works in practice can vary, but the intention is the same: to indemnify the insured should an insured event result in injury or a loss of property or of life.

Historically, there have been three basic corporate models for delivering this service: the incorporated mutual or cooperative, the stock company, and the less significant exchange

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10 IFSSR 2016.

11 IFSSR 2016.

12 The alternative terms "*takāful*" and "Islamic insurance" are both used in this publication.

(typified, for example, by unincorporated North American reciprocal exchanges). In recent years, a fourth model has emerged: a hybrid approach known as *takāful*. “Hybrid”, here, means that *takāful* has some of the characteristics of a reciprocal or mutual and some of those of a stock company with mutual protection of participants. Ownership of the *takāful* management company is legally with the stockholders, but insurance risks are shared exclusively among the participants (technically “contributors”). The demand for insurance products that are compatible with Islam has been growing for many decades throughout the Muslim world. For long periods, Muslim concerns with the treatment of *gharār*, or excessive uncertainty, and with the unacceptable presence of *maysir*, or speculative risk, in insurance have caused huge numbers of Muslims to shy away from entering into any kind of insurance contract.

Access to insurance, as part of a broad range of essential financial services, is especially important for poor households in order to smooth consumption, build assets, absorb shocks, and manage the risks associated with an irregular and unpredictable income. Without access to good formal insurance services, the poor depend on less reliable and often far more expensive informal-sector mechanisms. Yet, in the majority of Islamic countries, access to and use of insurance products has been quite limited, as many Muslims avoid such services over concerns about *ribā* (interest), *gharār* (uncertainty and ambiguity in contracts) and *maysir* (speculative risk), among other factors. *Takāful* products are emerging as a central part of the Sharī’ah-compliant family of financial services, helping to meet insurance needs in ways that are consistent with the local norms and beliefs of many majority Islamic countries. However, even after more than 30 years of the practice of *takāful*, there appears to be confusion among practitioners and the public about exactly what makes insurance prohibited, or “*haram*” (other than the obvious fact that insurance companies invest in asset classes that are *haram*).

*Takāful* has been developing steadily since the first Sharī’ah-compliant insurer was founded in 1979, based on a Sharī’ah-compliant cooperative model resembling mutual insurance. This model is based on a group of participants donating funds into a pool that members can then use in the event of specified unfavourable contingencies. While practitioners have applied varying business models, and standardisation remains a challenge, many policymakers recognise the potential of *takāful* as an opportunity to expand access to insurance and eventually to reach an untapped population and thus have aimed to promote the industry with supportive legislation and effective regulation. The response has been strong, with double-digit growth in premiums since *takāful* started. Premiums are forecast to reach USD 20 billion by 2017. This robust performance is expected to continue, based on substantial potential demand in those countries with a Muslim majority and improvements in the industry, including better distribution capabilities.



## The *Takāful* Business Model

*Takāful* complies with Sharī'ah principles related to how business should be conducted, but it does not compel the buyer of a *takāful* policy to subscribe to the other Sharī'ah principles that together make up the religion of Islam. When tackling a series of issues to establish an insurance system compatible with Islamic rules and tenets, we know that a basic fact always draws the boundaries: according to most Islamic jurists, conventional insurance is not aligned with Sharī'ah, the body of Islamic law, since it may involve fixed interest (*ribā*), excessive risk taking (*maysir*), uncertainty and unclear terms (*gharār*), and investment in unacceptable assets (*haram*). Within this framework, it is worth reviewing different countries' practices related to these various issues to the extent possible.

*Takāful* has three key features: it separates participants' funds from shareholders' funds; it adheres to a Sharī'ah-compliant investment strategy by avoiding the payment of interest and refusing to do business with firms engaged in forbidden activities; and it requires an independent internal supervision board of Sharī'ah scholars. However, at the end of the day, it provides coverage for people for their property/life and deals with risk management.

The following main Islamic insurance models are currently in practice:

- *takāful* models with segregated funds;
- non-profit model, as practised mainly in Sudan;
- cooperative model of the Saudi Arabian regulatory and supervisory body, the Saudi Arabian Monetary Authority (SAMA); and
- Turkish model.

## History of the Development of *Takāful*

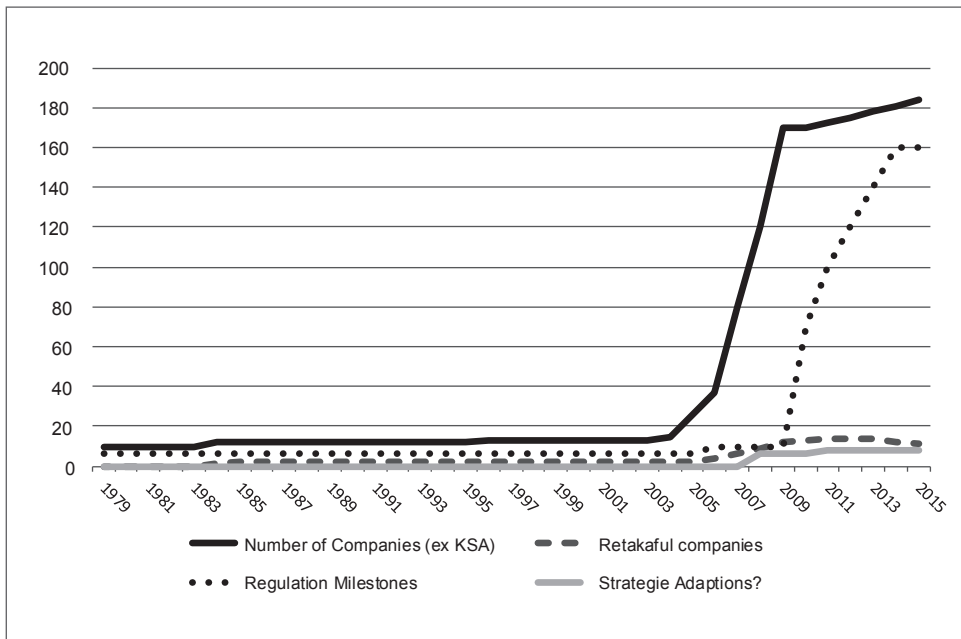
Achieving growth in the *takāful* sector and breaking through into the mainstream might be easier said than done. This is especially true because the *takāful* industry has faced, and faces, some challenges in achieving growth and coverage globally. A rapidly growing industry has a number of opportunities to set the stage for both short- and long-term growth, and to keep growing and reach untapped populations. The development of *takāful* can be illustrated in a sequence of three strategic phases, as identified below and illustrated in Figure 1.1:

- *Phase 1*: Slow, then a stormy wave of new companies in *takāful*, followed by *retakāful* but already retreating (Malaysian Retakaful, partly Munich Re, General Retakaful business).
- *Phase 2*: Development of Regulations and *fatāwā* for *takāful* and *retakāful*. Introduction of Risk Based Capital ((RBC) framework for *takāful* and *retakāful* in

Malaysia and RBC in United Arab Emirates. Further development on the 1985 *fatwā* for *takāful* by The Council of the International Islamic Fiqh Academy (IIFA) in 2013

- **Phase 3:** Slow down in the establishment of new *takāful* operators while existing operators and investors adjust their market strategies towards individual lines in a reaction to excessive volatility in financial results.

**Figure 1.1: Schematic Illustration of the Strategic Phases in the Development of *Takāful*<sup>13</sup>**



The key milestones in the development of the *takāful* industry are summarised in Table 1.1.

13 The axis denotes number of companies. The growth in the number of companies (arriving at 200 companies around 2011) is only schematically depicted. The sharp increase in the early 2000-years is equally schematic but can be shown by the incorporations in KSA, Malaysia, Kuwait and the UAE which are mainly documented on the respective websites. Incorporations in Retakaful capture mainly Takaful Re, Hanover Retakaful (2006), Munich Re and Malaysian Retakaful (2007) and ACR and Swiss Re 2008. The number of incorporations does not reflect the sharp increase in retakaful capacity.

**Table 1.1: Key Milestones in the Development of *Takāful***

Period	Milestones
<b>1970s</b>	<p>1976: First international conference on Islamic economics, held in Makkah, Saudi Arabia.</p> <p>1977: First <i>fatwā</i> issued by a higher council in favour of Islamic insurance/<i>takāful</i>.</p> <p>1979: First <i>takāful</i> launched in Sudan.</p>
<b>1980s</b>	<p>1980: Islamic Arab Insurance Company formed in Saudi Arabia and later in the UAE.</p> <p>1981: Dar Al Maal Al Islamic Trust formed in Switzerland to set up Islamic banks and <i>takāful</i> companies.</p> <p>1983: <i>Takāful</i> launched in Luxembourg with the establishment of <i>Takāful</i> S.A.</p> <p>1984: The <i>Takāful</i> Act enacted in Malaysia and <i>takāful</i> launched with the establishment of Takaful Malaysia.</p> <p>1985: OIC Islamic Fiqh Academy Resolution No. 9 prohibits conventional insurance and allows Islamic cooperative insurance – i.e. <i>takāful</i>.</p> <p>1985: <i>Retakāful</i> launched with the establishment of Saudi Takāful Limited.</p>
<b>1990s</b>	<p>1991: Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) registered in Bahrain. AAOIFI issues accounting, auditing, governance and Sharī'ah standards for Islamic financial institutions (IFI).</p> <p>1994: <i>Takāful</i> launched in Indonesia with the establishment of PT Syarikat Takaful.</p> <p>1995: <i>Takāful</i> launched in Qatar with the establishment of Qatar Islamic Insurance Company.</p> <p>1995: <i>Takāful</i> launched in Singapore with the establishment of Syarikat Takaful.</p> <p>1997: <i>Takāful</i> launched in Dubai with the establishment of Dubai Islamic Insurance Company.</p> <p>1999: <i>Takāful</i> launched in Sri Lanka with the establishment of Amāna Takaful.</p>
<b>2000s</b>	<p>2002: Lebanon–Al Aman Takaful established.</p> <p>2002: IFSB inaugurated in Malaysia. IFSB issues global standards and guiding principles for IFI.</p> <p>2003: First <i>takāful</i> company incorporated in Pakistan.</p> <p>2005: SAMA regulations for cooperative insurance supervision enacted.</p> <p>2005: Bahrain Monetary Authority enacts rules for <i>takāful</i> companies.</p> <p>2005: Securities and Exchange Commission of Pakistan (SECP) issues Takāful Rules in Pakistan.</p> <p>2007: Hannover Re enters the <i>retakāful</i> market in Germany.</p> <p>2008: <i>Takāful</i> launched in the UK with the establishment of Salaam Insurance.</p> <p>2008/9: Malaysian Re, Munich Re, Swiss Re enters the <i>retakāful</i> industry in Malaysia.</p> <p>2009: IFSB issues principles on <i>takāful</i> governance (IFSB-8) and Sharī'ah governance (IFSB-10).</p>

<p><b>2010s</b></p>	<p>2010: IFSB issues principles on solvency requirements for <i>takāful</i> (IFSB-11).</p> <p>2010: <i>Takāful</i> regulation introduced in the UAE.</p> <p>2010: <i>Takāful</i> launched in Brunei with the establishment of Takaful Brunei Darussalam.</p> <p>2011: Oman enters the Islamic finance sector following the lifting of decades-long restrictions on <i>takāful</i>.</p> <p>2011: <i>Takāful</i> launched in Kenya with the establishment of Takāful Insurance Africa.</p> <p>2011: <i>Takāful</i> launched in Palestine with the establishment of Al-takāful Palestine Insurance.</p> <p>2012: SECP draft Takāful Rules allow window <i>takāful</i> operations in Pakistan.</p> <p>2012: London-based Cobalt, set up in 2012 to promote the growth of <i>takāful</i>, announces the development of a new Sharī'ah-compliant insurance platform using a syndication model to spread risk more efficiently.</p> <p>2013: Bank Negara Malaysia (BNM) issues a concept paper on the Life Insurance and Family Takāful for Everyone (LIFE) framework. The proposals cover a wide range of areas, including operating flexibility, product disclosure, delivery channels and market practices. Once finalised, the initiatives will be reflected in the relevant policy documents to be issued under the <i>Financial Services Act 2013</i> (FSA) and the <i>Islamic Financial Services Act 2013</i> (IFSA).</p> <p>2013: Insurers in Indonesia await a new draft law that proposes a spin-off of their Sharī'ah-compliant units. Indonesia reshapes its capital requirements.</p> <p>2013: The <i>takāful</i> sector expands outside its core markets. In the GCC, for example, the growth potential of the industry in Oman is illustrated by the successful IPOs of operators such as Al Madina Takaful and new entrant, Takaful Oman.</p> <p>2013: Nigeria, which aims to become a hub for Islamic finance in Africa, issues guidelines for the centralised oversight of its fast-expanding <i>takāful</i> industry. In April, the vice chairman of the Chartered Insurance Institute of Nigeria (CIIN) is quoted as saying that <i>takāful</i> has now attained a 70% penetration level in the country's insurance industry.</p> <p>2014/15: Some (general) <i>retakāful</i> operations in Malaysia are closed or reshuffled.</p>
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*Takāful* was started in 1979, when Faisal Islamic Bank formed the Islamic Insurance Company of Sudan in response to demand for insurance in accordance with Islamic principles. This was also the key driver for development of the first *takāful* operator in Asia, Syarikat Takaful Malaysia Berhad, in 1984. Later, *takāful* operations started for various reasons, foremost among them being the need to satisfy the demand of Muslims for insurance and savings in accordance with Islamic laws. In the late 2000s in Malaysia, large multinationals were attracted to *takāful*, with the result that *takāful* became more widely accepted beyond Muslims. In some *takāful* operations, upwards of 60% of participants have been non-Muslims. The driving force for such business is the perceived fairness of *takāful* and the allure of profit sharing and transparency.

When compared with the early mutual, *takāful* was born into a world driven by regulations. From the start, a fairly strict loyalty to obligations was the primary concern. For that reason, these regulations have contained heavy capital requirements, which naturally have not facilitated a smooth development of the instrument. Therefore, the evolution of *takāful* has primarily been affected by the legal framework within which it operates. This is a rather problematic environment, and perhaps a serious impediment hindering further development. We can derive the conclusion that for *takāful* to succeed, its implementation must be on a holistic basis, and, in particular, regulations must cater to its unique features. This seems to be a prerequisite.

## Global Trends in Regulatory Initiatives for *Takāful*

*Takāful* has evolved into a rapidly growing industry that is now practised in 25 countries. More recently, *retakāful*, the equivalent of conventional reinsurance, has been developed, initially in Malaysia. At present, most *takāful* operators reinsure to conventional reinsurers, and this is considered acceptable so long as there is no practicable Sharī'ah-compliant alternative. It is worth noting that some countries' regulators in the different regions have demonstrated ambitious steps towards creating a more robust, resilient and regulated *takāful* industry, and this movement has made them and their markets indisputable leaders in the *takāful* industry. The *takāful* industry has advanced significantly over the past few years, particularly in the area of policy development and regulation. The Malaysian regulator, Bank Negara Malaysia, and the Bahraini regulator, Central Bank of Bahrain (CBB), are very progressive regulators. The UK, French, Irish and Luxembourgian governments have recognised the importance of Islamic finance and *takāful* by aligning some regulations with Sharī'ah-compliant principles. Key regulatory developments in different regions are discussed below.

### South-East Asia

Within South-East Asia (SEA), key Islamic finance jurisdictions such as Malaysia and Indonesia will remain key markets for the *takāful* industry. The successful growth of *takāful* in Malaysia is due primarily to that country's supportive regulatory environment and conducive business atmosphere, whereas Indonesia has taken advantage of the large untapped Muslim market. If the right products and regulatory supports are made available, the markets in both of the countries have the potential to expand.

The key legal and regulatory initiatives in Malaysia include the assessment process (ICAAP) for *takāful* operators, the enforcement of risk-based capital for *takāful*, the IFSA (2013), the separation of family and general *takāful*, and the introduction of new products by insurers and *takāful* operators. Similarly, Indonesia has introduced regulations for insurance companies and pension funds, proposed the phasing out of *takāful* window, and passed mandatory spin-off regulations to stimulate growth in the Sharī'ah insurance industry.

## **Middle East**

The GCC remains a highly competitive market with a large number of *takāful* operators. That market remains ripe for consolidation. A push for this may occur in the UAE as a result of recent regulations that introduced a risk-based capital model (akin to Solvency II in Europe). Increased capital requirements may provide the incentive for merger and acquisition activity.

Saudi Arabia and the UAE will remain as the key players in the Middle East region due to strong regulatory backup and increased awareness of the need for insurance and protection. The key regulatory initiatives in Saudi Arabia include the Insurance Corporate Governance Regulations, the Audit Committee's regulations on insurance and/or reinsurance companies, and the Surplus Distribution Policy. In the UAE, new regulations on governance, mandatory health insurance, financial status and investment allocations have been initiated. Similarly, in Bahrain the initiatives include revision of the existing *takāful* model, CBB enhancing its training and competency regime, and the introduction of standard policy insurance for motors.

## **South Asia**

In Pakistan, the Directive for Life Insurance and Family *Takāful* Illustrations and the Regulatory Requirement for Disclosure of Branch Information by Insurance Companies/*Takāful* Operators have been adopted.

## **Africa**

Sudan introduced a new Sharī'ah-compliant insurance platform, promoted Islamic microfinance, and updated its comprehensive regulatory regime for the sector in 2015. Egypt updated the current legal regime regulating insurance, is exploring the *microtakāful* area and has licensed two *retakāful* companies. Nigeria issued guidelines and registration requirements for *takāful* alongside its 2013 guideline for *takāful* operations. Several African countries, such as Kenya and Tunisia, are emerging *takāful* markets with niches marked by supportive regulatory initiatives.

## **Europe**

The main potential markets for the *takāful* industry in Europe are the UK, France and Germany, countries in which Muslim communities are concentrated. In countries such as the UK, Ireland, Germany and Luxembourg, rules have been adopted to enable the *takāful* model to operate alongside conventional insurance products. In the London market, the focus is on developing Islamic insurance in commercial lines of business. To this end, Cobalt Underwriting has now become not only a managing general agent for a number of global insurers, but also a cover holder at Lloyd's. In 2015, Lloyd's officially opened its new specialist underwriting platform in Dubai, providing another route into the market. There

are now 14 entities writing on Lloyd's paper in the Middle East and more are set to follow. A number of reinsurance brokers are also trying to establish operations in the region. We anticipate that this will lead to the underwriting of more risks by way of Islamic insurance and reinsurance. Similarly, Lloyd's has applied for an onshore licence in Malaysia, which we expect will boost the amount of Islamic insurance and reinsurance being underwritten. The Islamic Insurance Association of London has been formed with the aim of promoting Islamic insurance in the London market and beyond.

## International Regulatory Initiatives

Various organisations play an important role in promoting and guiding the stability and sustainability of the *takāful* industry. In August 2006, the IFSB<sup>14</sup> and International Association of Insurance Supervisors (IAIS) established a joint working group to produce an issues paper on the applicability of the existing IAIS core principles to the regulatory and supervisory standards for *takāful* to be developed by the IFSB.

The IFSB is an important international standing-setting organisation, publishing several key guiding standards for the *takāful* industry. They include: IFSB-18: *Guiding Principles for Retakāful (Islamic Reinsurance)* (2016); IFSB-14: *Standard on Risk Management for Takāful (Islamic Insurance) Undertakings* (2013); GN-5: *Guidance Note on the Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on Takāful and Retakāful Undertakings* (2011); IFSB-11: *Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings* (2010); and IFSB-8: *Guiding Principles on Governance for Takāful (Islamic Insurance) Undertakings* (2009).

The Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI) plays an important role in promoting consistency in the treatment of accounting and auditing standards for Islamic finance institutions, including *takāful*. The AAOIFI is an important international accounting, auditing and governance standards-setting and reviewing body, publishing several key guiding standards on accounting, auditing and governance, including: FAS-19: *Contributions in Islamic Insurance Companies*; FAS-15: *Provisions and Reserves in Islamic Insurance Companies*; FAS-13: *Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies*; and FAS-12: *General Presentation and Disclosure in the Financial Statements of Islamic Insurance Companies*.

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14 The IFSB plays an active and complementary role to that of the IAIS by issuing prudential and supervisory standards for *takāful* that are intended to safeguard both the interests of consumers and the soundness and stability of the financial system as a whole.

## Key *Takāful* Markets

Growth in the *takāful* sector has been driven largely by a handful of countries. It will be illuminating to start by focusing on those countries to gain an understanding of the prevailing trends. Specifically, key Islamic finance jurisdictions such as the GCC (led by Saudi Arabia) and SEA (led by Malaysia) have demonstrated a fertile ground for the *takāful* market, exhibiting continuous, double-digit growth for over a decade. In 2014, the gross *takāful* contribution in the GCC region reached over USD 8.9 billion. Saudi Arabia dominates the *takāful* industry in the region, absorbing over 77% of its total contribution.<sup>15</sup> The growth of the *takāful* industry in Saudi Arabia is predominantly driven by strong regulatory support and initiatives. For example, the Saudi Arabian Monetary Authority stipulates that all insurance companies in Saudi Arabia have to be established based on the cooperative business model. It is observed however that cooperative business model seems to be departing from the generally established *takāful* model in other jurisdictions. The main features of the regulatory/supervisory frameworks of Malaysia, Indonesia, Bahrain and the UAE were outlined above. Among these focused markets, Malaysia and Bahrain were perceived as being the leaders for setting transparent and specific rules for *takāful* companies. Since 2008, regulation has also evolved in other markets, but Malaysia and Bahrain are still at the forefront.

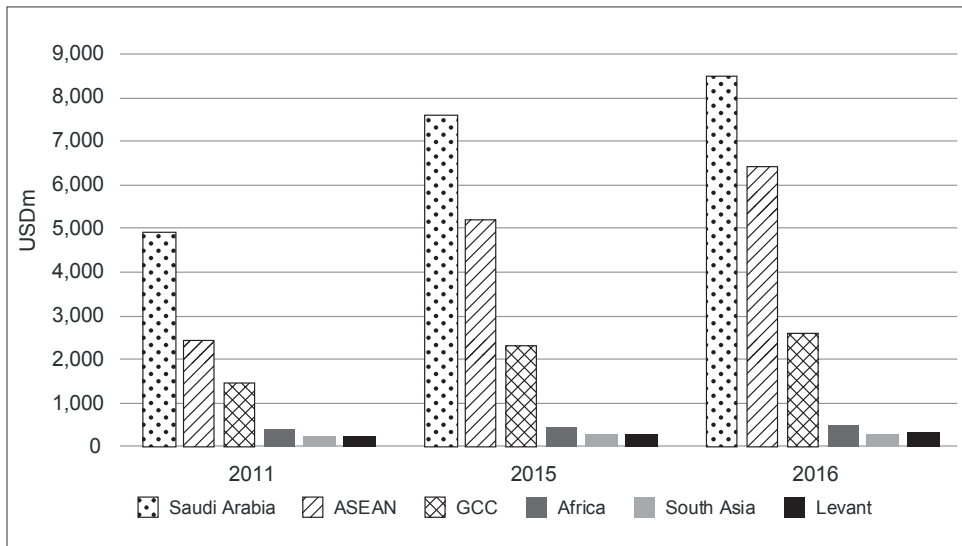
At this juncture, it is striking to see that four countries account for 90% of the total global market. We can therefore conclude that the ambivalent growth of the industry requires further analysis of the reasons for the underdeveloped state of *takāful* in a majority of countries. Even in the GCC, which has been one of the fastest-growing regions for *takāful* in recent years, growth has been uneven. Usage has been high in Saudi Arabia, underpinned by compulsory medical insurance, but take-up has been relatively modest in other GCC member countries.

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15 World Islamic Insurance Directory 2014, Middle East Insurance Review, EY analysis.



**Figure 1.2: Global *Takāful* Contributions Growth by Region, 2011, 2015 and 2016<sup>16</sup>**



After this brief mention of the negative side of the picture, it is worth noting that the concept of *takāful* has gained momentum over the last decade within the global *takāful* sector. Material growth in gross written contributions, which is expected to reach USD 20 billion by 2017, is a positive note. Saudi Arabia is the largest market, followed by Malaysia, the UAE and Indonesia. In terms of regulatory and supervisory approach, Malaysia and Bahrain are perceived as the most advanced countries. Malaysia has certain measures in place, such as tax incentives, that favour *takāful*; while Bahrain fosters *takāful* growth through harmonisation and standardisation. In the UAE, specific regulation has been introduced only recently.

The untapped population can be reached through the practice of hybrid business models, which combine a fixed-fee model for underwriting (*wakālah*) with profit sharing for investment activities (*muḍārabah*). Despite this trend of standardisation, there are persistent barriers to realising convergence. These barriers not only add to participants' existing confusion about the system, but also create an obstacle to industry growth. I would again like to emphasise the following observations: Although the *takāful* industry has changed rapidly and availability of *retakāful* capacity has undergone great change the development of *takāful* is still subject to controversial situations. The challenges of the rapidly growing industry are being gradually addressed, but plenty of areas of work still exist. Muslims account for a quarter of the world's population and they continue to have limited access to the benefit of insurance and data shows that the insurance penetration in Muslim countries is still comparably low.

<sup>16</sup> EY (2014), *Global Takāful Insights*.

It has been observed that the insurance penetration in the Muslim world in general and in the Arab world in particular is very low compared to the West and other developing regions.

The Muslim *ummah* (community of faith), which represents 25% of today's world population, is paradigmatic, as it has three peculiarities: (a) most of its members live in low-income or lower-middle-income countries, where the incidence of poverty is in general very high; (b) a tiny fraction of Muslims live in some of the richest countries in the world, with abundant liquidity and an accumulated wealth worth trillions of dollars; and (c) it has at its disposal equalisation tools such as the compulsory *zakat* and voluntary *ṣadaqah* (charity) that are meant to redistribute wealth but do not really fulfil their *raison d'être*.<sup>17</sup> In addition, attempts to introduce *takāful* there have resulted in limited access. There is a need to explore what drives the growth in *takāful* markets.

When we look at the data, it can be observed that the vast majority of contributions originate from Malaysia and Saudi Arabia. These two jurisdictions are considered to represent the key different business models/approaches to Islamic Insurance. Malaysia has been relatively successful in forming a vibrant *takāful* industry in the global *takāful* market. In contrast, despite the Middle East having large Muslim populations, the consensus is that the *takāful* industry is still struggling to establish a foothold and to penetrate the market. As is very well-known, Saudi Arabia's regulatory requirement to operate under the unified cooperative insurance model is distinctly different from the traditional *takāful* model. It is noteworthy, therefore, to focus on individual country practices to see how they tackle the related issues.

## Regional And Country Developments

Even though *takāful* comprises a very small Islamic banking and finance market share, the industry has realised substantial growth over the last ten years, in particular. A quick review of the Islamic finance jurisdictions such as the GCC shows that the region has proven to be a productive ground for the *takāful* market, demonstrating steady, double-digit growth for over a decade.

In the GCC, intense competition has undermined the profitability of *takāful* operators, some of which have started to explore alternative customer segments. Industry players view the lack of a uniform regulatory and supervisory framework that can allow them to operate across different models as a growth impediment. The successful demonstration of the *takāful* industry in the GCC has attracted cross-border interest and created opportunities for Shari'ah-compliant insurance in non-key Islamic finance jurisdictions such as Africa and Europe. In the African region, Sudan is the leading country in the *takāful* market, recording

17 Alberto G. Brugnoli (2014), *Takāful and Mutual Insurance: Alternative Approaches to Managing Risk*, Washington, DC: World Bank.

gross *takāful* contributions at CAGR of 23.4% during the period 2009–13. Family *takāful* contributed 58% of the total *takāful* contribution in 2013. Currently, there are 15 *takāful* operators in Sudan offering both general and family *takāful* products, with five of them providing *microtakāful*<sup>18</sup> products.

## **MIDDLE EAST–GCC**

In the GCC region, significant regulatory changes have happened since 2014. The regulators have improved standards and brought, to a certain extent, both their conventional and *takāful* industries to the international standards of the conventional insurance sector, such as an emphasis on risk-based supervision, capital and solvency policies. In the long term, improved regulatory and supervisory measures are considered to be better for the *takāful* firms in terms of capital management, liquidity, internal controls and corporate governance.<sup>19</sup> On the other hand, these measures are expected to increase the costs in the *takāful* sector, at least in the short run, due to the fact that many operators are working below their efficient scale with already high overheads. Indeed, 72 operators in the GCC region competed for USD 9.6 billion in gross contributions in 2014, with an average contribution per operator of USD 134 million.<sup>20</sup>

The introduction and extension of compulsory lines such as motor and medical insurance are the major drivers of gross premium growth in the GCC, because of the fact that over 80% of the business comes from the non-life segment.<sup>21</sup> According to a recent Standard & Poor's report, an important way for *takāful* operators to maintain and/or to increase their profit levels in mixed systems (where *takāful* competes with conventional insurance) is through product differentiation from their conventional counterparts, especially in the motor insurance market. Another option is to diversify away from the crowded market in the GCC by targeting unchartered markets with high potential growth in *takāful*, such as Africa.

## ***Saudi Arabia***

In the largest Islamic insurance market, regulatory changes resulting in a strengthening of technical reserves and the adaptation of actuarial pricing have impacted on the financial results of the motor and health *takāful* segments. On the other hand, the introduction of the new regulatory framework, such as those requirements making insurance obligatory for government vehicles, as well as the adoption of the compulsory motor third-party liability insurance for high-risk public premises, may lead to a boom in the market for the medium term. The strengthening of technical reserves was as a result of the Saudi Arabian Monetary Authority (SAMA) instructions to insurers to base their reserves on comprehensive actuarial

18 Malaysia International Islamic Financial Centre (MIFC) (2015), *Takāful: Growing from Strength to Strength*.

19 Standard & Poor's (2015), "Regulatory Changes Cause a Shakeout in Gulf Islamic Insurance Markets", *Islamic Finance Outlook* 2016.

20 IFSSR 2016.

21 Swiss Re (2015), *Re/insurance in the Middle East* 2014.

studies. Actuaries were instructed to adopt proper standards when assigning provisions and setting prices. This one-off impact was reflected in the insurer's balance sheets in Financial Year 2013.

It is worth noting that the significant number of total gross *takāful* contributions collected has made the region an indisputable leader in the *takāful* industry across the globe. This is particularly true given the domination of the GCC in the total market share of *takāful*, which accounted for almost two-thirds of the global *takāful* contribution in 2014. In particular, Saudi Arabia registered almost half (48%) of the global gross *takāful* market share contribution in that year. The remaining GCC countries contributed 15% of the global gross *takāful* market share<sup>22</sup>. Overall, the positive growth of the *takāful* industry in the GCC region is supported by a number of key drivers, such as stable economic growth, solid regulatory support and energetic initiatives, increased disposable incomes, increased awareness of the need for insurance and protection, and, not least, a preference for Sharī'ah-compliant insurance for religious reasons.

As noted earlier, SAMA explicitly states that the cooperative business model should be adopted by all insurance companies operating in Saudi Arabia. Despite the observation that the legislation tends to depart from the existing *takāful* model, the actual aim is to ensure that insurance companies in Saudi Arabia introduce a Sharī'ah-compliant model for their insurance business. After Saudi Arabia, the UAE is the second-largest *takāful* market in the GCC region.

### **Bahrain**

In 2006, Bahrain was the first country in the Middle East to introduce *takāful*-specific regulation. Its unique *takāful* framework is still considered the most advanced in the region. The framework takes a neutral approach to *takāful*, providing a level playing field between conventional and *takāful* companies. By setting a compulsory standard operating model for *takāful* companies (the regulator stipulates the use of a hybrid model for *takāful* insurers), it fosters a common understanding and harmonisation in the industry. There have been subsequently changes in 2014 regarding the treatment of *qarḍ al-ḥasan*.<sup>23</sup>

### **United Arab Emirates**

*Takāful*-specific regulation for the local market was introduced in 2010 with a measure called Resolution No. 4, which prohibits conventional insurers from offering *takāful* products via Islamic windows. The resolution stipulates the formation of a Supreme Committee of Fatwa and Sharī'ah Supervision, which issues binding legal opinions (*fatāwā*) for the *takāful* industry. On one hand, it prohibits *takāful* window operations as well as composite family

<sup>22</sup> EY (2014), *Global Takāful Insights*/Market updates.

<sup>23</sup> [www.oxfordbusinessgroup.com/news/changing-times-bahrain%E2%80%99s-Takāful-industry](http://www.oxfordbusinessgroup.com/news/changing-times-bahrain%E2%80%99s-Takāful-industry)

and general *takāful* companies. On the other, the resolutions allow the *wakālah*, *muḍārabah* and hybrid models to operate. (The *wakālah–waqf* model is not mentioned.) Furthermore, under the new legal framework, operators must provide a *qarḍ* against deficit in the *takāful* fund, and companies have to use *retakāful* rather than conventional reinsurance. The new regulations are a big step forward for the *takāful* industry in the UAE. Proposed rules address the key aspects of *takāful* business models, but uncertainty remains around the speed and degree of enforcement.

Significant corporate governance requirements now also apply to *takāful* operators, including specific requirements in relation to ensuring the Sharī'ah compliance of their operations. Given the government's desire to execute its vision of an Islamic economy over the next three years, the enforcement of these regulations may help to develop a more resilient *takāful* industry.

Between 2012 and 2015, the *takāful* industry in the UAE grew at an average rate of 4% annually with estimated growth above 5% in the coming years.<sup>24</sup> Despite these projections, there is certainly further scope for development/improvement. On the regulatory side, the UAE's Insurance Authority has engaged an industry-wide discussion on solvency, financial reporting and investment practices. Furthermore, the Authority has introduced new measures to scale up the regulatory and supervisory framework of the *takāful* industry, including putting in place the *Takāful Act*. The UAE's gross *takāful* contribution accounts for 15% of the regional total. The country has taken an ambitious step towards a more robust and resilient *takāful* industry. In addition to Resolution No. 4 of 2010, the UAE has established a Sharī'ah governance framework for *takāful* so as to ensure beginning-to-end Sharī'ah compliance in *takāful* business operations.

### ***Qatar***

Qatar contributed 4% of the market share in the GCC region, recording an average gross contribution growth rate of 26.6% for the period 2009–13 and collected a total gross *takāful* contribution of USD 384 million in 2014. The gross *takāful* contribution is projected to double from USD 273.4 million (QAR 995.6 million) in 2011 to USD 577 million (QAR 2.1 billion) in 2016.<sup>25</sup> Qatar's strong growth prospects for the *takāful* industry are substantiated primarily by strong economic growth, regulatory backup making insurance compulsory, heavy investment in government infrastructure based on Qatar's national development plan stretching to 2030, the impact of the rise of the expatriate population and, finally, the introduction of new insurance regulations.

<sup>24</sup> MIFC (2015), *Takāful: Growing from Strength to Strength*.

<sup>25</sup> MIFC (2015), *Takāful: Growing from Strength to Strength*.

## **Oman**

Oman is a new entrant to the Islamic finance sector following the lifting of decades-long restrictions on the sector in 2011. The country has moved quickly to develop regulations for *takāful*. The draft insurance law only permits the formation of full-fledged Islamic insurers, distinct from the provision made for Islamic banking windows. Draft regulations also state that *takāful* operators must be publicly listed and have a minimum capital of OMR 10 million (USD 26 million). To ease the difficulty of identifying suitable investable assets for *takāful* operators, Oman's Muscat Securities Market has launched a Sharī'ah-compliant index for investors seeking Islamic equities.

## **SOUTH-EAST ASIA**

The South-East Asian region, which includes countries such as Malaysia, Indonesia, Brunei, Singapore and Thailand, is also a key player in the *takāful* industry, contributing around one-third (30%) of the global gross *takāful* contribution, estimated at USD 4.2 billion, in 2014.<sup>26</sup> Key Islamic finance countries, Malaysia and Indonesia are the two main players in the *takāful* industry in the region, contributing more than 90% of the ASEAN *takāful* market share.

## **Malaysia**

Malaysia's three decades of *takāful* evolution have been characterised by the steady growth of market participants, including players, agents and consumers, and dedicated infrastructure capacity building. From an initial asset base of just RM\$ 1.4 million in 1986; the asset base of Malaysia's *takāful* industry has grown to a staggering estimated RM\$ 23 billion in 2014. However, the Malaysian Takaful Association (MTA), as the industry's central representative body, recognises that the country's *takāful* industry is yet to reach its optimal market participation level. To foster the industry's growth into 2020 and beyond, the MTA expects to continue its commitment and focused efforts to have Malaysian *takāful* lead the global *takāful* industry's best practices.<sup>27</sup>

In its aim to become a global hub for Islamic finance, Malaysia remains a pacesetter in terms of *takāful* regulatory developments. Its central bank, Bank Negara Malaysia, is the regulatory/supervisory authority and actively fosters *takāful* growth. Among the notable initiatives taken by BNM for the *takāful* industry in particular is the implementation of the "*Takāful* Operational Framework", which came into effect in 2012. Its objective is to enhance *takāful* business efficiency, ensure healthy and sustainable *takāful* funds, safeguard participants' interest, and promote uniform *takāful* business practices. The 2013 concept paper on the Life Insurance and Family *Takāful* for Everyone (LIFE) framework, in particular, was drafted to provide a wide range of guidelines on operational flexibility, product disclosure, delivery channels and market practices to the *takāful* industry in Malaysia.

26 MIFC (2015), *Takāful: Growing from Strength to Strength*.

27 Ahmad Rizlan Azman (2015), *Malaysian Takāful Dynamics – Central Compendium*.

Malaysia dominates the *takāful* market within the ASEAN region, contributing almost two-thirds (71%) of the *takāful* market share. With the aim of ensuring efficiency, and a healthy and sustainable *takāful* business operation, the country has taken progressive and impactful regulatory initiatives that also aim to protect the interests of participants. Moreover, the country has also announced its BRIM *takāful* plan, in its National Budget of 2014, to offer protection for low-income households (income less than MYR3,000) in the event of death and permanent disability due to accident.<sup>28</sup>

Malaysia's *takāful* market has been on a dynamic growth track, achieving double-digit growth momentum of about 19% and supported by a strong asset base of nearly MYR23 billion today. There seems to be a good potential in the region with Malaysia's lead on family *takāful*. As an emerging industry, there is huge scope for the *takāful* industry to raise its industry performance standards to a level comparable with the conventional insurance industry and to gain some momentum in the development of innovative products.

### **Indonesia**

The Indonesian regulator currently allows both full-fledged *takāful* companies and window-based operations, but companies can only offer either family or general *takāful* products. The regulator has strengthened the *takāful* operating framework via a measure introduced in 2010 requiring that companies establish a Sharī'ah control board and strictly separate shareholders' and participants' funds.

Indonesia, home for the largest Muslim population in the world, contributed 23% of the *takāful* market share in the ASEAN region in 2014. Currently, there are 45 Islamic insurance institutions, offering both general and family *takāful* products.

In 2014, the country passed a law that requires conventional insurance companies to spin off their Islamic windows into full-fledged entities within 10 years. This step will help to reshape the future direction of the *takāful* industry by encouraging mergers in the *takāful* market and direct the *takāful* operators to meet the new capital requirements. The law covers all areas of licensing, market conduct, corporate governance and consumer protection — for both *takāful* and non-*takāful*.

In November 2014, Indonesia's Financial Services Authority (OJK) introduced 20 new rules covering areas including governance, risks (credit, market, liquidity and operations) and minimum capital requirements. These new rules were effected in January 2015. In addition to regulatory reforms, the OJK introduced various five-year road maps aimed at strengthening the capital, banking, Sharī'ah and non-banking sectors.

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28 EY (2015), *Malaysian Takāful Dynamics – Central Compendium*.



## **AFRICA**

Africa is becoming a more important market for Islamic insurance and reinsurance. For example, Kenya's Insurance Regulatory Authority (IRA) plans to increase insurance penetration from 3.1% in 2012 to 3.5% by 2018 via the issuance of guidelines and a time frame for development of the *takāful* industry in Kenya. Kenya's regulator has introduced new *takāful* rules that will allow the entry of conventional players into the sector, which is part of efforts to boost capital markets in East Africa's biggest economy. This sees Kenya join countries such as Pakistan and Indonesia in initially allowing *takāful* windows, which enable firms to offer Shari'ah-compliant and conventional products side-by-side. Sudan leads the *takāful* market, recording a gross *takāful* contribution at CAGR of 23.4% during the period 2009–13.<sup>29</sup> Family *takāful* contributed 58% of the total *takāful* contribution in 2013. Currently, there are 15 *takāful* operators in Sudan offering both general and family *takāful* products, with five of them providing *microtakāful* products.

Other African countries have shown interest in further spurring on the *takāful* industry through various proactive regulatory initiatives.

## **EUROPE**

Europe offers a huge untapped potential *takāful* market. Despite the fact that Shari'ah-compliant insurance products have been offered in Luxembourg for more than a decade, the region does not exhibit any exciting developments in the *takāful* sector. London-based Principle Insurance was the only dedicated *takāful* operator in Europe, offering motor *takāful* products since 2008, but they became insolvent and went into run off in 2009.

Nevertheless, some Shari'ah-compliant insurance products have been offered by conventional insurance/reinsurance companies in Europe. For example, Munich-re, Hannover-re, Swiss-re and Scor introduced *retakāful* solutions to cater to Muslims' need for Shari'ah-compliant reinsurance services. Swiss Life has launched Europe's first family *takāful* products the primary aim of which is to facilitate French customers looking for Islamic investment solutions.

In Germany, FWU Group introduced a family *takāful* savings plan in 2012 which was distributed via financial intermediaries. Despite the lacklustre growth of *takāful* in Europe, but given the maturity of the market in the region, the *takāful* industry will potentially expand if the right products and regulatory supports are available. The main potential market for the *takāful* industry in Europe remains in the UK, France and Germany, where Muslim communities are concentrated.

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29 MIFC (2015), *Takāful: Growing from Strength to Strength*.



### **The Turkish Model**

A new frontier market for *takāful* is yet to see the entry of full-fledged *takāful* operators or even new *takāful* products by participation banks. Although Turkey remains a high-potential market for Islamic insurance in view of its large and young population, *takāful*'s supply-side constraints as well as limited legal infrastructure in the Islamic insurance sector are obstacles to *takāful*'s market growth. Turkey's *takāful* market dynamics are, however, gaining traction with the establishment of more participation banks.<sup>30</sup>

## **Global *Takāful* Business Risks and Challenges**

First and foremost, regulation is vital to ensure that people can feel confident in *takāful* products. Inappropriate regulation, however, can have a significant impact on the ability of *takāful* companies to function effectively and sustainably, and to supply the *takāful* products that individuals and businesses wish to purchase. In this regard, one particular problem observed is opposition to the hybrid business model or adherence to standardisation, which not only adds to the confusion of participants and consumers but also hinders the growth of the industry. To avoid confusion and remove the barriers, consensus is needed among Sharī'ah scholars in each country as to how *takāful* should be implemented. The regulatory architecture is a vital tool in this effort. While in some countries the government has to decide what "Sharī'ah-compliant" means, in other jurisdictions this may not be possible, and an early consensus among local scholars on how *takāful* is structured becomes important.

Countries differ widely concerning their regulatory responsiveness to *takāful*. For example, Malaysia is a leading regulator of *takāful* insurance, with guidelines covering capital adequacy, financial reporting, anti-money-laundering, and prudential limits and standards. Similarly, Bahrain's regulatory framework sets out explicitly the need to use the *wakālah* model for underwriting and the *muḍārabah* model for investment returns. This gives rise to a transparent market, but may stifle innovation. However, countries such as Singapore and the UK have no *takāful*-specific regulations, but host *takāful* entities. This lack of specific regulations makes the development of *takāful* more difficult.

The approach to developing *takāful* should also consider the level of sophistication/level of development of the insurance market in the country. The key challenges that need to be addressed in the *takāful* sector are discussed below.

<sup>30</sup> Recent developments include the state-run banks Ziraat Bank and Halkbank, which will establish two participation banks and enter the market. Presently, four banks are operating in the participation banking landscape (Bank Asya, Türkiye Finans, Albaraka Turk and Kuveyt Turk) and they constitute 5.3% of the Turkish banking industry. By the end of 2015, the Turkish Government plans to establish three state-owned Islamic banks as subsidiaries of the current state-run conventional banks. The three state-owned banks – namely, Ziraat Bank, Halkbank and Vakıfbank – will each have an Islamic, interest-free bank.

## Distribution of Surplus

The question of fund distribution is growing in importance. When should the operator distribute underwriting surplus, and to whom? Given that initially the *takāful* participants are wholly dependent on shareholders capital to ride out claims volatility how much should be retained as operating risk capital? After assessing these various enterprise risks, both the risk pool and the operator will need appropriate levels of risk-based capital. On both sides, the regulatory framework has yet to mature in most countries. Questions of corporate governance and regulation are also becoming more important. Participants are rarely represented on *takāful* boards, while Sharī'ah supervisors are often unfamiliar with technical insurance issues. Who protects the interests of participants? Regulators need to take as strong a position as possible because the current framework does not protect participants sufficiently. Further business challenges include the need to have suitable investment opportunities (the success of *takāful* is likely to be materially dependent on having good access to a wide range of *sukūk* bonds and a deep and liquid *sukūk* market) and the need to achieve customer loyalty. *Takāful* promotes the prospect of surplus sharing, but where any accumulated *qarḍ* needs to be repaid there is a risk that customers will become dissatisfied.

Transparency issues are among the key problems regarding *takāful*. Contracts need to be simple and transparent. Standardised, simple paperwork that is customer friendly adds much to the attractiveness of the instrument. However, in most countries, there is no standardised policy form. The relationship between policyholder and the *takāful* operator should be clear, with regulations requiring open declaration of (a) the operator's fee and (b) the *takāful* operator's policy (and perhaps history) regarding payment of any surpluses to participants. Malaysia and Saudi Arabia regulate to limit intermediary commissions, but many countries do not. Companies should be required to treat customers fairly. Most countries have some regulation in this respect.

## Corporate Governance

The risk and governance process for *takāful* needs to be considered on a holistic basis. Indeed, we should not be talking about starting *takāful* businesses but, instead, about building a *takāful* market. The two are different. Allowing *takāful* to operate like insurers will, in my opinion, only result in Sharī'ah-compliant insurance companies, not *takāful* operators. The consumer outcome will not be very different under the Sharī'ah-compliant insurance model. Should this happen, we would then lose the opportunity to offer a differentiated consumer experience to the public, whether Muslims or otherwise.

The various levels of corporate governance should be regulated, including the responsibilities of the board of directors and of the Sharī'ah advisory board, and the role of actuaries, who have a key responsibility for setting both loss reserves and pricing. Most countries require Sharī'ah certification, which undoubtedly promotes good practice. The approach to solvency

standards is evolving. While *takāful* may develop for a period, with participants trusting the promise of surplus sharing, unless the *takāful* operating model chosen is appropriate for the particular solvency standards, the likely path will be of diminishing surplus sharing with increasing price competition. So, the *takāful* model selected and the regulatory capital requirements need to be set with this in mind. A basic reality should not be overlooked when considering a wide range of issues in this regard: while a tiny minority of Muslims have extraordinary wealth, the great majority live in low-income or lower-middle-income countries where the incidence of poverty is high. So, policymakers, as in other areas of the economy and finance, should consider the cost of living and the needs of lower-income people when introducing *takāful* in their jurisdictions, to ensure that *takāful* operators introduce products that are appropriate and affordable taking account of the harsh realities of life.

### **Distribution Channels/Reaching Untapped Population**

One important goal is to reach the huge group of people in the lower income bracket. A key means of doing this is through *microtakāful* products. A critical challenge is that the target policyholder is accustomed to addressing risk only after the loss occurs. By contrast, the mainstream buyers of *takāful* are keen to manage risk *before* the loss occurs. Therefore, a sound distribution channel is critical. Options include the following:

- (i) a normal *takāful* operator;
- (ii) a partnership between a *takāful* operator and an Islamic microfinance institution;
- (iii) a community-based model;
- (iv) a provider model (i.e. via a hospital, clinic or other cooperative); and
- (v) a social protection model.

Furthermore without any doubt, a very important aspect of Islamic societies related to solidarity is the religious tenet of *zakaat*. This fourth pillar of Islam, *zakaat* is neither a tax nor a charity, but rather a devotional financial obligation targeted to specific groups of the society. When channelled appropriately, it has funded some of the most successful forms of *microtakāful* programme. Keys to success here are achieving distributional cost efficiencies, providing financial education (a vital challenge), choosing products appropriate to the customer (i.e. mainly life risks/protection products and not savings products), working closely with the distributor, avoiding all/minimising commissions, and streamlining claims settlements. Nevertheless, a wide range of *microtakāful* products have been delivered effectively, including life, health, crops, property, livestock, funeral, flood, personal accident, and even unemployment. Many of these products have been tailored to regional needs.

As an emerging industry, the *takāful* industry has wide scope to raise its industry performance standards to be on par and indeed even exceed the conventional insurance industry and to accelerate the development of innovative products. The *takāful* industry must also strive

to deliver a positive and engaging digital platform to access a broad base of increasingly technologically savvy customers.

### **Appropriate Regulation and Supervision**

Thus far, the range of *takāful* regulation in practice is very wide. Malaysia is often considered to have the most *takāful*-supportive regime. In contrast, Bahrain's approach is very rules-based. In other words, too much regulation can be a major impediment to the development of *takāful* and makes the system cumbersome. Certainly a "cut and paste" approach to introducing *takāful* regulations in a country is to be avoided as regulations are designed to cater specifically to the current phase of development of insurance generally in the country. It is also not appropriate to mimic the conventional insurance regulations in the country when establishing *takāful* as this would more than likely restrict the potential of *takāful* in the country to complement the existing insurance market.

It is to be noted that there is something problematic with the promotion of *takāful*. Indeed, countries with large Muslim populations have been slow to recognise its importance. There is much to be achieved by taking a constructive approach to regulation. Perhaps it is necessary to place more focus on reducing the bureaucracy and eliminating redundant rules that make it difficult to reach various segments of the populations.

The legal framework should be tailored to meet the needs of the local population and local business practices while also, of course, being aligned with Shari'ah rules. For example, the local business environment and culture of the country will determine the most suitable form of regulation: cooperative (as in Saudi Arabia) or mutual (as in Sudan and the West). As indicated earlier it would be a gross error to assume that regulating *takāful* is the same as regulating commercial insurers. On the contrary, *takāful* is a hybrid structure that presents unique challenges to regulators.

Where *takāful* is regulated separately there are effectively two "regulators" – the need to conform to Shari'ah principles, while also conforming to financial constraints. There are even two boards – the Shari'ah advisory board and the board of directors. Do auditors sign off on Shari'ah compliance? Reimbursing participants with surplus is much more complex than paying dividends to shareholders, should there be regulations surrounding surplus distribution. (For example, different policies may develop surpluses at different times in their development.) Questions of "substance over form" regarding the admissibility of "*takāful* windows" need careful consideration. It is not acceptable for a commercial operator to sell products under a *takāful* branding if the products are not truly *takāful* in nature.

Solvency standards are a unique challenge because of the difficulty of evaluating the participants' commitments to continue paying contributions should there a deficit in the *takāful*

pool. Another concern is the appropriateness of the investment instruments accumulated in the *takāful* fund, for example whether certain types of *sukūk* are admissible and whether they have a good credit standing. The need to generate and retain capital within the *takāful* risk pool is always going to conflict with the need to distribute surplus to participants. The conflict between the need for the operator's shareholders to see returns on their investment in the *takāful* company and for the participants to see a refund of contributions through a distribution of surplus is another source of tension. The role of *qarḍ* is fundamental in *takāful* when benefits are effectively guaranteed and the solvency and accounting treatment of *qarḍ* is a continuing matter for debate.

### High Set-up Costs

Another challenge is the cost of setting up a *takāful* system. The conventional insurance system is not suitable for *takāful* as, in particular, it is not set up to handle the multiple funds concept and the sharing of any surplus among the participants. Additional costs need to be incurred to establish a distribution network, along with infrastructure and logistics. We have to work on how these costs can be reduced and what incentives could be introduced – for example, reducing the tax rates or introducing tax incentives or subsidies in the beginning stages.

Windows, which offer cost synergies, may be a solution to this, although the Sharī'ah scholars prefer stand-alone companies. Furthermore notional fund segregations, which are practiced in *takāful* windows, are not recognised in any resolution.

### Lack of Trained Personnel

In many instances, we see the new *takāful* company recruiting from the insurance industry. But the *takāful* sector needs more experienced *takāful* practitioners who can think and work within the parameters of the basic *takāful* concepts. They have to deal with a new set of customers and adopt approaches rather different from the conventional status quo. Some have had to make do with untrained graduates. These inadequately trained staff could even become counterproductive in certain instances. A proper understanding of the differences between *takāful* and insurance is necessary when strategising the business (as opposed to a purely Sharī'ah) model. These differences would need to be communicated effectively to employees across the company. Recruits from the insurance industry easily fall into the misconception that managing *takāful* is the same as managing insurance. This is not helped by the fact that in many developing countries, there is already a general lack of trained insurance personnel what more *takāful* personnel. As a result of this lack of human capital, when new insurance/*takāful* companies are set up, staff costs go up across the industry (as salaries are pushed up) but the technical competency of the industry as a whole drops as the number of experienced personnel per insurer is reduced.

### **Cost to Adhering to Regulations**

In many countries, especially non-Muslim majority ones, *takāful* companies incur additional regulatory efforts/costs as compared to insurance as the local regulations may not be *takāful* friendly. This can lead to a marketing disadvantage when competing with conventional insurers. The capital requirements (minimum capital and solvency computation basis) are usually geared towards regulating a risk-transfer model with guaranteed benefits. *Takāful* is primarily a risk-sharing model. If given the necessary regulatory support, the *takāful* model is better at promoting financial inclusion. A biased attitude seen in the regulations towards managing a risk transfer market would, over time, result in compromises having to be made to the *takāful* business model. We have also yet to see regulations that place an equal emphasis on solvency and promoting micro insurance.

### **Competition with Conventional Insurers and *Takāful* Companies**

In many markets, *takāful* competes with more established insurers on the basis of price. This is especially so when it comes to compulsory personal lines such as motor and health insurance. In such instances, the newly set-up nature of *takāful* means that the *takāful* entity is caught between two difficult options: compete on price and incur operational losses; or set higher premiums than the market at the expense of losing market share and incur losses due to expense overruns. A better alternative is to differentiate through product innovation.

Price competition with other *takāful* companies is even more unfortunate when *takāful* operators compete among themselves to provide the product at “cheaper” prices. The fundamental concept of *takāful* is risk sharing, not risk transfer. On a risk-sharing basis, the concept of cheaper products should not arise, as any surplus is distributed back to the participants. To mitigate this, there need to be a technical basis imposed on *takāful* pricing.

### **Expectations of *Takāful* Shareholders**

In many markets, we see unreasonable expectations placed on *takāful* management by shareholders. The risk-sharing nature of *takāful* by definition means there will be lower profits available to shareholders. For multinationals, a strong case will need to be made by management to their home office board for why shareholders should accept a lower return on investment (ROI) for their *takāful* business as compared to insurance. Due to the unreasonable profit expectations of shareholders, the *takāful* business model has had to make compromises in terms of the principles on which *takāful* is based.

### **Lack of Sufficient Shari’ah-compliant Asset Class**

In order to provide a good product to participants, *takāful* operators need to have access to suitable Shari’ah-compliant asset classes in which to invest their premiums.

## Policies to Promote the Global *Takāful* Industry

It would be unrealistic to expect that one *takāful* model would be accepted globally. There are practical reasons why *takāful* models vary from country to country, and not just Sharī'ah reasons. Arguing which is the more “correct” model is therefore a waste of time. Instead, the important question is whether the model is acceptable to the majority of Muslims in the country. The recommendations given below should be considered in that light:

- (i) **Establish training programmes and focus on capacity building for *takāful* personnel.** This can be established on a regional basis. (Train the trainer, etc.)
- (ii) **Invest in developing an affordable generic *takāful* computer system than can be leased to *takāful* operators globally.**
- (iii) **Provide funding for countries to develop their own appropriate regulations for *takāful*.** It is noticed that many countries use a “cut-and-paste” approach to formulating their *takāful* regulations which would, more likely than not, inhibit, rather than encourage, the growth of *takāful*. The legal framework should be tailored according to local people’s needs and the business practice of the particular country.
- (iv) **Promote a public–private partnership to develop *microtakāful* in developing countries.** It would be a misplaced trust to expect that profit-driven *takāful* companies would undertake to promote financial inclusion when doing so would mean they have to accept taking higher risks for lower profits.
- (v) **Identify suitable shareholders to start up *takāful*.** These are shareholders whose primary objective is to promote *takāful*, rather than seeing *takāful* as a means to generate profits immediately. Provide support for re-thinking and widening the product and distribution strategies, to differentiate the *takāful* industry more clearly from the conventional market (“blue ocean versus red ocean strategy”). Provide assistance to develop the Sharī'ah asset classes necessary to support the *takāful* industry.

## Conclusion

Strong economic and population growth will support the growth of the *takāful* industry globally. We should not forget that the unique characteristics of *takāful* make its success somewhat dependent on a supportive regulatory environment. The hybrid nature of its set-up (management company combined with mutual risk pool) makes it difficult for *takāful* to thrive in an environment that promotes only stock companies or only mutual. The regulatory approach in countries where *takāful* coexists with conventional insurance has been to encourage *takāful*, but not to favour one above the other. The exception is Saudi Arabia, which has closed down all *takāful* operations as we understand it. Instead, demanding that all insurance companies including those that call itself *takāful* to adhere strictly to the



predefined cooperative insurance regulations, which have still to be ratified as Sharī'ah-compliant.

Malaysia has certain measures in place that favour *takāful*, such as tax incentives, while Bahrain fosters *takāful* growth through harmonisation and standardisation. In the UAE, specific regulation has been introduced only recently. To avoid confusion and remove the barriers, consensus is needed among Sharī'ah scholars in each country as to how *takāful* should be implemented. The regulatory architecture is a vital tool in this effort. While in some countries the government has to decide what "Sharī'ah-compliant" means, in other jurisdictions this may not be possible, and an early consensus among local scholars on how *takāful* is structured becomes important.

There remains a largely untapped market for Islamic insurance, but buyers need to be persuaded that Islamic insurance solutions exist and that they are a competitive alternative to conventional products. The facilities that are now available in the London market and the ongoing initiatives in local markets will hopefully lead to greater education and a more extensive range of products, which should strengthen the message that Islamic insurance is also a viable risk management tool for corporates across the Muslim world.<sup>31</sup>

In summary, *takāful* has enormous potential to enhance and upgrade the lives of Muslims throughout the world. The elimination of the uncertainties of life to the extent possible is an invaluable contribution to people's lives. It can be influential in many aspects of life, as it can cover life, health, property, motor and liability risks, and also reach the smallest families and the poorest communities through *microtakāful*. *Takāful* also has enormous potential to enhance the economic development of the Muslim world. As we have seen on our quick review, the path is not without challenges. Whether these are on the investment front, the operational management front, the educational front, the distribution front, or the regulatory front, there are dynamic concerns on all sides. But in each case, good solutions are possible. What is required is for these challenges and the possible solutions to be more widely known and appreciated by the various segments of the finance and insurance community. It is critical to open these issues for debate and to try and reach agreeable solutions together. Consensus on controversial issues can be achieved through related parties taking constructive approaches. We need to take more responsibility, and to use this channel more effectively for the prosperity of our people. We believe that decisive and determined cooperation will lead to sustainable results for *takāful* both in the short and long term.

31 Susan Dingwall, Partner, Norton Rose Fulbright LLP and Martin Schneider, Associate, Norton Rose Fulbright LLP (2016), "The Outlook Ahead", *Islamic Finance News*



# CHAPTER 2: REGULATORY DEVELOPMENTS AND IMPLICATIONS FOR THE INDUSTRY: CONTRASTING THE VARIOUS APPROACHES TO REGULATING *TAKĀFUL*

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James A. Smith

## Introduction

Islamic insurance, including both what is called *takāful* and other forms of insurance that are stated to be Sharī'ah-compliant, enables customers to meet their needs for protection using contracts and from companies that maintain Sharī'ah compliance. The topic of differences in understanding or interpretation of Sharī'ah – leading to situations in which one person may accept a form of contract as Sharī'ah-compliant, and a second considers that it is not Sharī'ah-compliant, both acting sincerely – is not the author's competency (though, in a regulatory context, even a secular regulator must be aware of the risk). The comments in this chapter are intended to relate to every form that its proponents believe to be Sharī'ah-compliant, whether or not it is called *takāful*.<sup>32</sup>

When considering regulation, it is necessary to accept that, for regulatory purposes, *takāful* is considered to be part of the universe of insurance, not least because in most of the jurisdictions of the world it appears reasonable to expect that that is how it will be regulated, and indeed how it will be viewed when the IMF performs reviews under its Financial Sector Assessment Programme. The principles espoused by the global standard-setting bodies are intended to be of wide application – the challenge for those responsible for supervising the *takāful* sector is to work out how those principles may be appropriately applied, whether as a separate regime for *takāful* or as modification for *takāful* business under the insurance regime, without creating arbitrage that is detrimental to the interests of those who rely upon *takāful* for protection, but without creating unnecessary obstacles to the operation of *takāful*.

One premise, which may be controversial at first glance, is that most *takāful* contracts are contracts of risk transfer, albeit of transfer from the individual to a group of which that individual is a member. Through the medium of that group the individual is also accepting risk transfer from other members, so acting as both insured and insurer. However, whereas full risk transfer would leave the individual exposed to the risk that the pooled assets are insufficient to meet the total of the liabilities, the practice of *qarḍ* has evolved to enable the downside risk to be smoothed.

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32 While this chapter covers regulatory issues generic to insurance/*takāful* business, Chapter 5 deals with regulations specifically related to reinsurance/*retakāful* business.

That premise does not preclude the possibility of policyholders being responsible for funding deficits on a real-time basis. Some such organisations do exist – the mutual ‘Protection and Indemnity Clubs’ in the marine market are an example. However, this chapter assumes that those purchasing *takāful* cover do so in the expectation that their contribution is all they have to pay, and that valid claims will be paid. Indeed, some *takāful* is sold on the basis that surplus contributions will be refunded. Little, if any, is sold on the basis that the participant will be asked for more. Hence, this paper considers *takāful* along with conventional insurance, but concentrates on its specificities.

Neither does the premise preclude the possibility of a parallel, complementary sector based on contributions to a common fund where benefits are of a relatively low level and depend on there being money in the fund. Such arrangements, of which discretionary mutuals are an example, may have a particularly useful societal role in extending protection and financial inclusion.

## The International Regulatory Architecture for Insurance

Insurance, like banking, was an early mover into globalisation, and cross-border operations taking the form of subsidiaries and branches have long been a feature of the insurance landscape in some countries. Very few jurisdictions have maintained entirely domestic sectors; at the least, accumulations of risk are pooled internationally by the mechanism of reinsurance or similar. The existence of cross-border activity raises obvious questions of regulatory arbitrage and distortion of competition, and the protection of branch customers in one country if the company headquartered in another country experiences financial difficulties. Cooperation between national regulators concerned about cross-border activities has led to the development of international organisations of regulators, which have issued standards including for insurance (with further development a work in progress), and the Global Financial Crisis provided added urgency. Policymakers have expended much energy and resources during the years following the financial crisis, developing standards in response to perceptions of weaknesses in their approach, and sharing expertise as to how risks should be addressed, in practice as well as in theory. A new focus on financial stability has provided added pressure for cooperation across sectors as well as across borders.

The Basel Committee on Banking Supervision was one of the first organisations to attempt to set down minimum standards for the prudential regulation of internationally active financial institutions, in its case for banks and banking groups. Founded in 1975 by the governors of the central banks of the Group of 10 countries, the “Basel Committee” has established standards for a number of aspects of banking prudential supervision, now viewed as the international norm and generally applied. The Basel Committee was followed by IOSCO, the International Organization of Securities Commissions (IOSCO), founded in

1984 and dealing with international standards for securities markets. It, too, has achieved authoritative status in its field, though, like the Basel Committee, it does not have power over national regulators – whether and when to adopt international standards is always a local question. In 1994, these two international bodies were joined by the International Association of Insurance Supervisors (IAIS), and it is on this part of the international regulatory architecture in financial services that this chapter focuses.

International cooperation on this global scale came later to the insurance sector than to banking, and insurance regulation remains less consistent. Comparisons of national frameworks show a patchwork of different approaches moving, it is true, in the same direction, but at different speeds and with a considerable degree of variability. The pace of change, though, has picked up in recent years, and it is not fanciful to view the IAIS as working towards a similar status to that of the Basel Committee. There are a number of reasons for the slower development of insurance compared to banking.

- (i) Banking is clearly a critical element of the financial system in that banking failure can cause rapid and widespread disruption to the financial system in a country and beyond. The insurance sector is less obviously a source of risk to the system, since while insolvencies do occur their impact tends to be spread over time.
- (ii) Related to the above points, policymakers have seen the damage that banking failures can do. There is less experience of shocks to the insurance sector (though not no experience).
- (iii) The banking industry is more obviously integrated internationally compared to the insurance industry.
- (iv) Whereas the Basel Committee consisted of a small number of very influential central banks (those standing ready to provide credit to the IMF), the IAIS has had from the start a broad membership. This broad membership possibly hindered the IAIS from taking as decisive a role in forming supervisory policy as its banking counterpart, though doubtless it facilitated capacity building among insurance supervisors.
- (v) There is arguably less consensus among supervisors on the way in which aspects of the insurance sector should be regulated and supervised, than there is for banking. Even among policymakers in the industrialised countries, lengthy debate has taken place on matters such as the validity of consolidated supervision in a group context.

The slower pace of development of standards for the insurance industry has not prevented the development of a corpus of Insurance Core Principles (ICPs), with a particular landmark being their reissue in 2011. There are 26 ICPs, each supported by more detailed standards and guidance material; the compiled version runs to some 400 pages. They are

designedly structured, as the IAIS states, to allow a wide range of regulatory approaches and supervisory processes to suit different markets and the range of insurance entities and groups operating within these markets. The IMF has for some time used these principles (together with their equivalents from the Basel Committee and IOSCO) in carrying out its Financial Sector Assessment Programme, and specifically its reports on a country's observation of standards and codes.

The IAIS views its standards as providing a three-tier framework, of which only the most universal tier is currently complete (though under constant review). The ICPs are meant to be universal, for all insurance activities; work continues (as will be described later) on a Common Framework for the supervision of internationally active insurance groups, to harmonise the application of supervision for the largest insurance groups in a way that the Basel principles were developed for banks; and a third tier applies to those groups that are considered to be systemically important on a global scale.

These three associations of regulators cooperate in a body called the Joint Forum, focusing on cross-sector issues.

It would not be possible to conclude a discussion on the global architecture without mentioning the Financial Stability Board, which has driven the development of specific standards for those financial institutions (including insurers) that are deemed to be globally systemically important, in that their failure could threaten the stability of the global financial system. The Financial Stability Board was first established in 1999 as the Financial Stability Forum, and was re-established as the Financial Stability Board in 2009, at a time when the Global Financial Crisis was still in recent memory. It is sponsored by the Group of Twenty major economies (the "G20") and, with that mandate, has promoted the reform of international financial regulation and, in particular, the areas of how to deal with financial institutions experiencing stress, so as to minimise the fallout for the broader economy. Initially focusing very much on banking, this body has since expanded its view and has designated a number of insurance groups as systemically important. The IAIS has been tasked with the development of policy measures for such groups, as mentioned above.

Financial services regulation does not take place in a vacuum and entities carrying on financial services activity are also subject to other forms of regulation, many of them similarly tending towards global improvements in practice – for example, data protection, privacy and employment rights. It is worth mentioning in this context the International Accounting Standards Board, responsible for the issuing of international financial reporting standards (IFRS), now widely used or aligned to by national accounting frameworks. The Basel Committee, IOSCO and the IAIS are all members of the IFRS Advisory Council.

So far, this section has set the scene for financial services in the wider sense, and has not mentioned Islamic financial services. The architecture is supposed to provide a broad enough framework for all forms of financial services. With its focus on outcomes, it would be self-defeating for the framework to exclude Islamic financial services, even if one could identify a clear boundary between conventional financial services entities and Islamic financial services being regulated, that did not depend on form rather than substance.

However, the same desire for exchange of experience and cooperation between regulators is also evident in the Islamic finance world, as well as a perception that application of the global regulatory framework to Islamic financial services will throw up challenges that regulators might not encounter in conventional financial services, most obviously the issue of Shari'ah compliance. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was founded in 1991, with a declared mission of seeking standardisation and harmonisation of international Islamic finance practices and financial reporting in accordance with Shari'ah. The IFSB was officially founded in 2002 and develops standards for regulatory and supervisory agencies of the Islamic financial services industry.<sup>33</sup> Both aim to cooperate with the international standard-setting bodies so far described, and to develop new standards, or adapt existing ones, to promote the stability of the industry. The IFSB does not issue Shari'ah standards or accounting and auditing standards, whereas AAOIFI does both. The IAIS and IFSB produced a joint paper on issues in the regulation and supervision of *takaful* (Islamic insurance) in 2006, and have since signed a working agreement on their cooperation. Both also issued a joint paper on Issues in Regulation and Supervision of *Microtakaful* in November 2015.

The architecture described above had its origins in the idea that harmonisation and cooperation was most needed for entities carrying on cross-border business, but it is perhaps inevitable that, once a regulator has accepted the use of harmonised international standards for cross-border operations, it will apply them also to insurers that operate only domestically, to avoid distorting the domestic market. The development of minimum standards for internationally active insurers promotes the application of those minimum standards to all insurers. This is one reason why *takaful*, a sector that has tended to operate within national silos (or at best, for *retakaful*, regional ones), is affected by moves to international harmonisation. Another is that regulators, when they see what look like good ideas being practised elsewhere, may wish to adapt them for domestic use, to improve regulatory efficiency and customer protection.

The development of a global framework for insurance regulation has been a blend of perceived need and practicality, slowing the pace of development. Many markets retain

33 Unlike different organisations dealing with regulatory issues for different sectors in conventional finance, the IFSB is a standard-setting body for Islamic banking, *takaful* and capital markets.

some protectionist features, and there is fear that capital and governance standards designed for advanced industrial societies will be unsuitable for a local industry that lacks the skills and resources to apply them, let alone the data to do so, and simply reduce the availability of insurance. Progress has been gradual, while capacity has had to build.

At the same time, though, major jurisdictions were on a clear path to sophisticated supervision, following the lessons from the “London Working Group” report<sup>34</sup> that risk management and governance, and not just capital, were critical to insurer resilience. Simple capital metrics had been progressively abandoned since the 1990s, with few countries still using simple premium metrics and almost all of those somewhere on the path to reform by the time the Global Financial Crisis struck. It predominantly involved shocks to the banking sector, showing a lack of resilience in stressed conditions in that sector. Even if that had not fed through to concerns as to the resilience of the broader financial sector, there were issues in the insurance sector, one in particular requiring cross-border coordinated action by insurance supervisors on a considerable scale, in countries previously unused to it. To a large extent, the urgency gave another push to reforms and accelerated the developments that we now discuss.

## Regulatory Developments in the Insurance Sector

The need for regulation in the insurance sector has long been recognised, focusing mainly on prudential regulation to increase the probability that claims will be paid when needed. Consistency has been lacking, partly reflecting a history of relying upon judgements of individuals as to what would be prudent, and partly too reflecting the difficulty of determining what is a suitable level of capital to absorb volatility in an industry whose very function is to absorb volatility. International bodies have made great progress in this area of prudential regulation, and there is now for the first time a realistic prospect of an international standard for capital adequacy in insurers. Capital is, however, but one feature of the prudential regulatory “package” that applies to all insurance, including *takāful*; conventionally, the package is thought of as having three prudential “pillars”, being capital adequacy, governance and risk management, and disclosure (to regulators and to the public),<sup>35</sup> and this three-pillar language is used in this paper. This is not a rigid distinction; in particular, there is a strong interdependency between the first two pillars – the risk profile determines

34 *Prudential Supervision of Insurance Undertakings* (Conference of the Insurance Supervisory Services of the Member States of the European Union, 2002). The report presented anonymised causal analyses of instances of insurance failure or near-failure and highlighted emerging trends in the risks faced by insurance companies.

35 The practice of organising or analysing supervisory frameworks into three “pillars” was originally a feature of the Basel framework for banking supervision. It was introduced in modified form into the structure of the EU’s Solvency II framework for insurance (see KPMG (2002), *Study into the Methodologies to Assess the Overall Financial Position of an Insurance Undertaking from the Perspective of Prudential Supervision*, European Commission). Although the term “pillar” does not even appear in the adopted text of the Solvency II Directive (European Directive 2009/138/EC), the concept has passed into the vocabulary both of Solvency II and, by extension, of risk-based regulatory frameworks for insurance more generally.

the amount of capital needed, but poor management of risks implies greater operational risk and hence higher loss before the adverse effects of an incident can be controlled, meaning more capital is needed. This three-pillar model does, however, provide a framework within which the specificities of *takaful* can be accommodated.

In addition to prudential regulation, there is increasing interest in regulation of conduct of insurance business. Poor business conduct represents a reputational and financial risk for insurers. It has long been accepted that “buyer beware” is not a suitable principle for this financial service, and regulators have proven increasingly willing to punish insurers and intermediaries for approaches that result in outcomes that are detrimental to consumers. Growing awareness of consumer rights makes it easier for consumers to assert those rights. Increased flexibility of product design also increases the scope for customer confusion. *Takaful* poses extra challenges for policymakers in this area that have not yet been fully explored. However, conduct regulation is predominantly a national, rather than an international, matter.

## Prudential Regulation

### *Capital Adequacy*

Insurers are relied upon by customers for the transfer of risk; that reliance is pointless if the insurer will not be there when it is needed. Insurers use a variety of mechanisms to provide resilience. All insurers retain capital (contributed capital, or earned surplus) to absorb higher-than-expected claims, and regulations invariably impose a minimum level of solvency, or several threshold levels triggering increasingly severe regulatory intervention, with a view to ensuring that valid claims can be paid. At one time, the amount of capital was often either arbitrary or based on simple metrics. This is not the case now, and capital requirements are almost universally tailored to a company's risk profile. The IAIS ICPs require the use of risk-sensitive capital requirements (ICP 17), and a variety of models have been developed in different jurisdictions.

Solvency requirements have also become more forward-looking, assessing capital needs on a prospective basis rather than using only historical metrics. The move towards risk-based capital requirements has been in progress for decades, as advances in technology have improved the reliability of measurement of risk. From their genesis as early warning systems in the United States in the early 1990s,<sup>36</sup> jurisdiction after jurisdiction has developed risk-based capital (RBC) models of more or less sophistication, to meet the requirements of their

<sup>36</sup> [www.naic.org/cipr\\_topics/topic\\_risk\\_based\\_capital.htm](http://www.naic.org/cipr_topics/topic_risk_based_capital.htm) (National Association of Insurance Commissioners, page accessed 26 August 2016).



own jurisdictions.<sup>37</sup> It is hard to describe RBC as a recent development, but the trend from simple prescribed formulae to complex prescribed formulae to sophisticated capital modelling is in evidence. The implementation in 2016 of Solvency II in the European Union was for some affected countries a matter of the regulations catching up with supervisory practice.

Simply applying formulae to a company's numbers would overlook one aspect that is of the essence in most forms of *takāful* – that is, the separation of the funds attributable to policyholders and those attributable to the owners of the company. This feature may also be seen in forms of conventional insurance, and regulatory frameworks acknowledge that capital is not necessarily fungible, not within a group and not necessarily even within a company. Cross-border operators will be familiar with the need to maintain capital within a country where they have a branch, this capital not being available to absorb losses in other branches or the home jurisdiction. The practice established in the United Kingdom in the 1870s and replicated in a number of countries (though largely abolished in the UK in 2016) of requiring life insurance business to be maintained in one or more life insurance funds, ring-fenced from the company's other business, is another example. In these cases, surplus in an identified part of the company is not available, or at least not unconditionally available, to meet losses arising in other parts of the company. This principle of “fungibility” is recognised in the Solvency II framework in the concept of “ring-fenced funds”. It follows in the context of capital adequacy that segregated funds must be assessed separately, and surplus identified that cannot be transferred internally. IFSB standard IFSB-11 on solvency requirements for *takāful* undertakings reflects this principle of fungibility, by recommending separate capital adequacy for the segregated funds, with capital support only from the shareholders' fund to the policyholders' funds. *Takāful* also recognises, where “window” operations are allowed, a need to ring-fence the (Sharī'ah-compliant) operations of a window from the (Sharī'ah non-compliant) operations of its host company. Fungibility, in short, is well understood in *takāful* as an issue, and the role of shareholder capital in *takāful* operations presents particular challenges.

A further consideration, of particular reference to *takāful*, is the risk of counting capital for more than one purpose, so-called double-gearing. In *takāful*, deficits in policyholder funds may often be supported by loans (*qarḍ*) from shareholders' funds. If such a loan is counted as an asset of the shareholders' fund, at the same time as being counted as capital supporting the policyholders' fund, double gearing would result. The rules attaching to recognition and valuation of assets and liabilities at fund level in any capital adequacy framework for *takāful* are of critical importance, so that not only is the position of funds clear, but the extent of cross-subsidy is transparent. Of particular concern are situations

37 RBC is now an established or developing feature of capital adequacy regimes in major insurance markets, including the EU, the US, Canada, China, Japan, India, Bermuda, Brazil, Australia, Switzerland, South Africa, Singapore, South Korea and Hong Kong, as well as many smaller national markets.



where participants' funds are in persistent deficit such that shareholder funds are not merely providing a contingent capital buffer but are in fact absorbing losses of the participants' funds on an almost permanent basis.

One barrier to the introduction of a risk-based capital requirement for insurance business is that, while standard approaches might be developed for assets, the liability side of the balance sheet and in particular the technical provisions of the company for the insurance obligations (or obligations under *takaful* contracts) adopted could have an enormous range of profiles, and no standard approach could realistically cater for all of the possible risk profiles of companies. Even a matter such as working out a "capital charge" for catastrophe risk (i.e. where a natural disaster or other major event would result in a large volume of claims) will depend greatly on what the business written is, and what the catastrophe is (itself, to some extent, a function of geography). The profile of the liabilities also affects the risk profile of the assets. Accordingly, a formulaic approach developed for one jurisdiction is not necessarily appropriate elsewhere, and is not necessarily appropriate for all insurers in that jurisdiction, either. Hence the need for insurers to develop their own internal models to assess their capital needs, and the possibility under some regulatory frameworks that such internal capital models may be approved for regulatory capital adequacy purposes.

The difficulty of developing a single baseline capital model has not prevented the IAIS from embarking on the development of a Common Framework for the Supervision of Internationally Active Insurance Groups (hereafter "ComFrame"). ComFrame is intended to provide an international standard for insurance supervision, to harmonise the application of the ICPs for the largest insurance groups with significant cross-border activities. While the number of such groups is relatively small (something over 50), and is unlikely to include much *takaful* business, the tendency is for international standards to become adopted as national ones sooner or later.

A major part of ComFrame is the development of an Insurance Capital Standard (ICS), risk-based and calibrated to a 1 in 200 probability of inadequacy over a one-year horizon, which at the time of writing is being developed and field-tested. Other aspects of ComFrame are discussed further below.

The IAIS is committed to completing development of its first version of the ICS by mid-2017. Following further testing and refinement with supervisors and affected insurance groups, the IAIS plan is for groups within the scope of ComFrame to provide private reporting to their supervisors under the new ICS, starting from 2020. Subsequently, the IAIS will explore the possibility of using internal and external capital models to alleviate the weaknesses of a standard formula model. Ultimately, its goal is to provide a common solvency methodology to be applied across jurisdictions, yielding broadly comparable outcomes.

To be actually applicable in each country, an international ICS will need to be adopted into national regulation. The experience of banking demonstrates that such adoption is possible, but suggests that the time frame is long. Nonetheless, the very existence of an ICS, and its use in international comparisons, will provide an incentive for adoption.

Regulatory capital adequacy is not the sole measure taken into account by insurance groups, and for larger groups at least the level of regulatory capital required rarely bites, since capital management policies are focused rather on maintaining external ratings. To satisfy one of the major credit rating agencies that a company or group warrants an “A” rating is usually more onerous than meeting a regulatory capital requirement. Similar principles are, however, involved: the determination of capital that is available, and the level of capital that is required.

In addition to increasing sophistication of capital adequacy requirements, the global insurance market has also seen heightened focus on the risks of contagion within groups of companies and the possibility that distress in one part of a group will cause problems in another. (The epidemiological term “contagion” is used to describe this.) The ICPs cover insurance group supervision (ICP 23) and the possibility of contagion across different parts of the financial sector is also recognised in laws in various jurisdictions, some prohibiting particular relationships between insurers and banks, others imposing requirements for group supervision of financial conglomerates. Two particular approaches are taken to group supervision; one being treating a group as a single economic entity, with solvency needs and governance requirements on a consolidated basis, and the other being to monitor closely the relationships and transactions between group members, an approach sometimes called “windows and walls” (not to be confused with *takāful* windows). These two different approaches have been the subject of much debate, in particular between the EU and the US, in discussions as to their equivalence. In practice, of course, a regulator applying one of these two approaches will invariably also introduce aspects of the other.

The relevance of group supervision to much of *takāful* may be limited at the present time, as groups of *takāful* companies are not common, though there are many examples of conventional financial groups that include *takāful* or *retakāful* companies. For such groups, the supervisor of the parent group has to consider risks to the group arising from the *takāful* or *retakāful* company, and the supervisor of the *takāful* or *retakāful* company has to consider risks to that company arising from its membership of the group. Both reasons, communication and cooperation between supervisors, facilitate supervision of companies and groups. Recent years have seen development of “supervisory colleges” to enable supervisors of companies in groups to coordinate their activities and cooperate. Supervisors of *takāful* companies are unlikely to be convenors of supervisory colleges, but they may well be invited to be members of supervisory colleges convened by conventional

insurance or conglomerate group supervisors. Advances in communications continue to make discussions between supervisors easier to conduct remotely; enabling a level of engagement that at one time was simply impracticable.

A discussion of capital adequacy would be incomplete without mention of the measures being taken in response to the Global Financial Crisis, relating to financial stability. These may at present be of limited practical relevance to *takāful*, due to the small size of the sector. However, the ICPs do require a regulatory regime to consider the “macro prudential” perspective (ICPs 24 and 26).

Mention was made above of the Financial Stability Board (FSB), established in the wake of the Global Financial Crisis. Its initial focus was on the banking industry, and the vulnerability of the financial sector to the existence of banks that are “too big to fail”. The FSB has also paid attention to the risk that some insurance groups may similarly be too big to fail, because of the impact that their failure would have. Following debate as to the circumstances in which insurance operations could represent a threat to financial stability, the IAIS was tasked with developing a methodology for the identification of insurance groups that are globally systemically significant, and policy measures for those insurance groups that were deemed to fall into that category (of which there are currently nine). These policy measures included the assessment of group capital adequacy according to a base capital requirement that would be determined according to the risks of the group. To this would be added additional capital requirements where they are needed to ensure that groups “too big to fail” would not do so, under foreseeable circumstances. The determination of the base capital requirement is intended to be replaced in time with the ICS mentioned above.

No *takāful* operation is likely to be considered to be of global systemic significance, though some may be (and indeed are) part of conventional insurance groups that are. Financial stability is not, however, a concern only at the global level, and it is entirely possible that *takāful* operations could come to be considered systemically important at the national, or regional, level. The principle of separation underlying many *takāful* operations may reduce this likelihood, but all insurance regulators may be expected to develop their thinking on systemic risk and the role of insurance in that. This is an area where policy is still under development.

### **Governance and Risk Management**

Capital adequacy is a prominent aspect of prudential regulation but not the sole one, and research performed by the London Working Group<sup>38</sup> in the early years of this century, examining a number of insurance failures and near-misses, highlighted the fact that insurers

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38 Refer to footnote 34 above.

accept risks for which capital is not always a sufficient answer, and that a common factor in failures and near-misses was a failure by companies' systems and processes for identifying and managing risks. The recommendations of the London Working Group were influential in the development of what became the Solvency II Directive in Europe, which includes extensive qualitative requirements in respect of governance and risk management, often referred to as "Pillar 2" of the Solvency II system. The ICPs similarly place great emphasis on risk management (ICPs 8, 13 and 16, in particular). Regulators have always required insurers to manage their business prudently, and the involvement of actuaries, particularly in life insurance, has evidenced an awareness that insurers are subject to risks that need to be managed. However, the detail now being required to deal with the governance of risk extends into areas that might not previously have been considered, such as operational independence of key governance structures, fitness and propriety requirements for individuals, remuneration and incentive structures, outsourcing and reputational risk.

As with capital adequacy, international regulatory policy on risk management is principles-based, with a view to ensuring that risk management occurs and is properly governed, rather than setting out detailed requirements, although even a principles-based framework for risk management is necessarily quite detailed, and the ICPs cited above are among the longest ICPs in terms of text, once their explanatory material is included.

Three IFSB standards in particular have sought to keep the *takāful* sector abreast of developments in these areas of insurance regulatory policy, being IFSB-8 on governance and IFSB-14 on risk management in *takāful* undertakings, and one generic across the Islamic financial sector being IFSB-10 on Sharī'ah governance. Special characteristics of *takāful* include the need for Sharī'ah compliance (and therefore the risk of Sharī'ah non-compliance, which is not a feature of conventional insurance) and the requirement for segregation of funds, a feature that is not unique to *takāful* but requires *takāful* undertakings to consider the interests of different stakeholders, where those interests may conflict, and how the *takāful* operator is able to reconcile conflicting interests when the operator itself may be in a conflicted situation. For example, the attribution of expenses as between the participants' fund and the shareholders' fund affects the financial position of both funds; profits to the operators can be increased at the expense of persistent deficits in the participants' fund.

In the insurance sector, asset–liability management is a critical area for governance, and is referred to in IFSB-14 on risk management in *takāful*. Segregation of funds complicates asset–liability management because of the presumption against cross-fund support, and the more limited universe of funds available for investment of *takāful* funds is a further complication.

Risk management also forms an aspect of the IAIS's ComFrame project, building on the ICPs in the areas of governance and enterprise risk management. ComFrame, being designed for internationally active insurance groups, will make specific provision for risk management and disclosure in respect of group structures, and an analogous expectation can be read across to *takaful* undertakings. In the same way as ComFrame will require transparency in group structure disclosure of group structure and strategy to group regulators, supervisors of *takaful* undertakings may be expected to require transparency in the internal structure of the undertaking, between the various funds making it up. ComFrame will require a group to analyse risks arising from its structure and strategy and demonstrate how such risks are managed. A *takaful* undertaking's supervisor could similarly expect a *takaful* undertaking to demonstrate how risks arising from its structure are managed. It is difficult for qualitative requirements to be prescriptive and it is therefore expected that ComFrame will focus on outcomes.

ComFrame is an ambitious project and it would be foolish to underestimate the hurdles that remain in its path. Not least among these is continuing debate among policymakers in key jurisdictions as to how certain risks should be addressed. In the absence of a single obviously "right" answer, it can be difficult to achieve consensus. Still, once complete we may expect ComFrame to be strongly influential in the way that the Basel Accords became, providing a global standard for cross-border business that will inevitably come to be reflected in national insurance regulation.

### ***Other Prudential Matters***

The third "pillar" of prudential supervision, after capital and risk management, is often thought of as reporting, both privately to the supervisor and publicly (dealt with in ICPs 9 and 20, respectively). The justification for such reporting requirements is twofold. For the first of these, the provision of information to the supervisor in a standard form enables the supervisor to carry out the analysis that it needs to do in order to perform its assessment of the risks facing the insurer and to supplement its own observations from on-site inspection and other interactions with the insurer. In the case of information to be made public, the information enables investors and creditors in the insurer to assess its financial position and performance, and to compare it with other insurers, and enables policyholders and potential policyholders to assess the security of the institution on which they are relying (or intending to rely). In addition, placing information in the public domain acts as an incentive not to engage in activities that may be perceived as improper.

The details of regulatory reporting are often seen as a national matter. A degree of standardisation is emerging in public reporting, by way of International Financial Reporting Standards; however, not all jurisdictions adopt these and in any case the consistency of public reporting in insurance even under IFRS is hindered by delays in the finalisation of

the IFRS specific to insurance, IFRS 4 on insurance contracts. The manner in which IFRS 4 should be applied to *takāful* has also been the subject of debate, particularly in Malaysia when the local public reporting requirements were aligned to IFRS. The domestic accounting profession discussed various aspects of *takāful*, though no formal guidance was issued.

An AAOIFI accounting standard for *takāful* has existed for some years, and is adopted in some countries, though it could not be applied in countries where IFRS is required.

Both private and public reporting for insurance have come to include significant amounts of qualitative as well as quantitative information. In the Solvency II framework, an extensive narrative report is required at both solo and group level, as well as detailed quantitative reporting, and IFRS 4 requires risk disclosures of a similar nature to those required for financial instruments. In the case of *takāful*, the information on which users of public reports rely would include qualitative information on how the participants' funds are managed, including aspects that illustrate how the separate interests of operator and participants are reconciled. A tendency towards more detailed reporting may give participants (or perhaps more likely, journalists and industry analysts) an enhanced opportunity to identify matters such as the attribution of income and expenses to the different funds, and comparative levels of *wakālah* fees.

Mention should also be made of financial crime and money laundering, which are also the subject of ICPs (ICPs 21 and 22). Recent developments in associated areas include criticism of tax avoidance, potentially by means of using reinsurance to carriers domiciled in low-tax jurisdictions. The OECD project on Base Erosion and Profit Shifting has prompted further disclosure, with country-by-country reporting.

Finally, the package of policy measures applicable to global systemically important insurers, introduced at the instigation of the FSB, includes requirements for planning for recovery and resolution, the so-called living will. Although this current requirement applies only to global systemically important insurers, the FSB has issued Key Attributes of Effective Resolution Regimes for non-banking financial institutions, for the guidance of policymakers, and recovery and resolution planning is under consideration as a regulatory requirement in some jurisdictions. The relationships within a *takāful* undertaking render particularly complex the identification of recovery triggers and actions, development of recovery planning, and development of resolution regimes. Moves to make recovery and resolution planning a standard requirement in the insurance sector could result in additional administrative burden on *takāful*, or on groups that include *takāful* businesses.

## Conduct Regulation

International regulation of insurance business has tended to concentrate on prudential matters, and conduct of business has rather been a national responsibility. An ICP on this topic (ICP 19) comments: “Conduct of business, including business practices, is closely linked with jurisdictions’ tradition, culture, legal regime and the degree of development of the insurance sector. For this reason, regulatory approaches to the conduct of business also tend to vary.” The impact of conduct of business regulation on *takaful* is similarly dependent on the jurisdictions in which they operate.

Some comments may however be made, since ethical behaviour, good faith and prohibition of abusive practices are requirements shared by many jurisdictions, particularly so far as concerns, insurance in retail markets where the asymmetry of knowledge and financial power is particularly marked.

Some aspects of conduct regulation practised in different countries may represent exposures for *takaful* and barriers to *takaful* operation in those countries for structural reasons, though others represent no difficulty.

Contract certainty is one of the latter. Clarity of contract is widely seen as desirable in a contract, and some reinsurance markets in particular have in the past been accused of a culture of “deal now, detail later”, resulting in ambiguity or dispute if insured events occurred before the detail was determined. The introduction of a culture of contract certainty in the London insurance market was made under threat of possible regulatory intervention. Certainty of contract is also a tenet of contracts under Sharī’ah, as excessive uncertainty (*gharār*) is prohibited.

The role of intermediaries in the insurance market is extensive, and the types of intermediary used vary. The ICPs concentrate on regulation of insurers, though ICP 18 on intermediaries sets out material for supervision of intermediaries. However, the distribution channels used by insurers and *takaful* operations are potential sources of risk to the insurer, as selling practices by intermediaries have the ability to mislead customers. In such situations, questions arise as to how far the responsibility of the insurers extends. The UK’s conduct regulator has given attention to insurance sales by intermediaries that do not represent value for money to the customer, but are highly remunerative to the intermediary rather than to the insurer. In such cases, failure by the insurer to supervise those selling its products, or agreement to inappropriate incentive programmes, could expose the insurer to disciplinary action or reputational risk. While the payment protection insurance scandal in recent years in the UK has affected the reputation of the intermediaries concerned, rather than the insurers, expectations as to insurers’ responsibilities for intermediaries selling their products have evolved over the years.



Distribution of *takaful* products varies. Best reports<sup>39</sup> that *takaful* products in the Middle East are primarily sold through broker and agency distribution channels, whereas in Malaysia the sector makes extensive use of bancassurance (or *bancatakaful*) as a distribution channel. In either case, the intermediary has potential conflicts of interest, with the possibility of sales being aimed at maximising intermediary revenue rather than providing the best service to the customer. *Takaful* companies need to consider the incentives that they provide to intermediaries, in a similar way that conventional insurers are also increasingly required to consider the impact on customers of the sales practices that they adopt themselves, or that they incentivise in intermediaries.

In the field of *takaful*, there is an additional dimension, as in many jurisdictions where *takaful* is present: a customer is able to choose not only between *takaful* products offered by different operators, but also between *takaful* and conventional insurance products, to meet the same need. In this latter case, the claims made by companies and intermediaries as to the Sharī'ah compliance of their products raise issues of shared understanding of Sharī'ah compliance. Countries with central Sharī'ah authorities may be able to control the risk of disputes as to Sharī'ah compliance by requiring approval of those authorities; however, in the case of non-Islamic countries (as well as some Islamic ones), the reasonableness of assertions as to Sharī'ah compliance of contracts and operations falls to the Sharī'ah governance of the *takaful* companies themselves and the regulator's capability may be limited to assessing whether governance is present and effective, rather than assessing the result.

The IFSB has issued a standard (IFSB-9) setting out guiding principles on conduct of business for institutions offering Islamic financial services. This standard provides, in addition to guiding principles, illustrative examples and recommended practices for institutions, some of these being specific to the *takaful* sector. It emphasises ethical behaviour, including transparency and the management of conflicts of interest, as well as the paramount role of Sharī'ah compliance by the institution.

The business models of some *takaful* companies, and the regulatory frameworks within which they operate, allow surplus arising in the policyholders' risk fund to be distributed to participants, rather than being retained as accumulated reserves of the fund. Such *takaful* companies need to be aware of the risk of creating expectations as to distribution, and the appropriateness of promoting distribution as a selling point, in particular where the operation relies on the use of *qarḍ* to meet capital requirements and absorb losses on a temporary basis. Expectations of distribution may persist even when there is no surplus, creating customer dissatisfaction, and those sold contracts on an expectation of distribution

39 A.M. Best (2016), *The Dynamics of Takaful Markets of the Middle East and Malaysia: Similar Models, Different Approaches, Contrasting Fortunes*, London, A.M. Best



at a time that the participants' fund has *qard* to repay may feel that they have been misled when surplus emerges but they have no share. Regulators in such a situation face a difficult balance between protecting the interests of participants who are already members of the fund, so that their valid claims will be met, and ensuring fair treatment of new entrants to the fund, any surplus on whose contributions will go first to repay *qard*. Furthermore, the transparency that principle would suggest is necessary to allow fair treatment of new participants could result in adverse selection, such that new entrants actively avoid funds that have *qard* to repay, and existing participants renew their cover with other providers instead. This consideration may be a weakness of the surplus distribution model, as compared with models whereby surplus is accumulated as capital to absorb future deficits and the level of that accumulated capital is managed through pricing.

The manner of surplus distribution may also raise questions as to fairness. Although the principle of attributing surplus to the participants is relatively simple, it is not clear how the actual amount to be returned to each participant should be determined. IFSB-9, described above, does not address the matter. The standards of AAOIFI provide for two main methods (distribution in proportion to contribution, and distribution only to those not making a claim, together with a third method representing essentially a hybrid of the two), though both are open to criticism. Simple distribution to those who were members in the year may be unfair to those who have been participants for some years and whose renewal was relatively inexpensive to administer. A model where distribution is only made to those who did not make a claim raises questions about the validity of effectively allocating a supposedly unconditional donation first to the donor's own interest, as well as creating a disincentive to make a valid claim. Regulators focusing on consumer outcomes could find both of these approaches problematic.

Insurance regulators' supervision of conduct of business is primarily focused on consumer protection; however, some also have a mandate to consider the competitive nature of the market, and to limit anticompetitive activities. This is not a feature of all financial services regulatory frameworks; however, different operators do seek competitive advantage and supervisors need to be aware of the risk that competitive keenness leads insurers to act inappropriately with regard to conduct.

## Key Policy Issues and Challenges for *Takaful* Regulators

In developing regulatory standards for *takaful*, regulators have to deal with a number of policy issues. These may vary from regulator to regulator, not least because not all regulators will have explicit responsibility for Sharī'ah supervision, though no regulator, even a secular one, can ignore Sharī'ah, if only as a governance issue and conduct and reputational risk exposure.

### ***How Far Risk Sharing May be Reflected in Regulation***

Insurance regulation is invariably predicated on risk transfer, and a pure risk-sharing model where participants are responsible for funding deficits (solvency, as well as actual) would be difficult to maintain in regulation, except in specific areas where the participants are both willing and able to provide that funding (the P&I Clubs being an obvious example). In the case of retail insurance, however, it must be doubted whether a pure risk-sharing model could ever be considered viable (or effective) as a competitor to conventional insurance.

This is necessary when one considers a key social function of insurance, which is the protection of those who may suffer damage, and that the person damaged will not necessarily be the policyholder (e.g. in the case of motor third-party liability insurance). It may reasonably be questioned whether a person's chance of compensation for damage should be different depending on whether the person responsible for the damage had taken out conventional insurance or *takāful*. This is a key reason why *takāful* is regulated on a similar basis to conventional insurance; because it is fulfilling a similar role, and in the great majority of jurisdictions (exceptions being those where conventional insurance is not permitted) it competes with conventional insurance.

It is certainly possible that exceptions can be found. In UK insurance regulation, small operations that practise true risk sharing are not regulated as insurance; such institutions operate on the basis that benefits are payable on the basis of the funds available. Such a model becomes less viable as the volatility of the risk grows. A parallel may be drawn with microinsurance and *microtakāful*, as forms of social protection aiming to provide low benefits with limited volatility. The role of such organisations in enhancing financial and social inclusion is potentially significant in some countries (and even where it is not, the low impact of failure can be used to argue for only limited regulation). Policymakers may consider that there are net benefits from keeping organisations of this nature outside the full scope of the regulatory framework.

### ***Qarḍ***

The role of shareholder capital in *takāful* is complicated, as it must provide loss absorbency for the risks of the shareholders' fund (e.g. the risk that expenses properly borne by the *takāful* operator rather than the participants are not covered by the remuneration received from the participants' fund), but it also stands ready in most cases to provide support to the participants' fund should that fund experience a deficit compared to its liabilities or fund solvency requirement (where such requirements exist). That support is provided by way of loan (*qarḍ*) from the shareholders' fund to the participants' fund, to preserve segregation between participants' and shareholders' funds as though they were separate undertakings. This ability of a *takāful* undertaking to cover a deficiency (or a liquidity need) in the participants' fund by way of *qarḍ* is a key feature of some models of *takāful*, though

intra-entity loans are not unknown in some forms of conventional insurance where internal segregation is present. In principle, a *qard* is repayable from future surpluses arising in the participants' fund, though the question of what happens in practice if no such surpluses ever arise seems rarely specified in regulation.

The likelihood that *qard* will be needed is reduced if capital is contributed, or surplus retained as reserves, in the participants' fund to enable that fund to meet its own capital needs. Due, however, to the inherent volatility of general *takāful* business in particular, even operations that retain surplus for this purpose may still need the capability to call on *qard* as a backup source of funds if the level or incidence of claims is particularly high.

Shareholder capital thus has this potentially anomalous role in absorbing volatility in a participants' fund from which in principle it is strictly segregated. For shareholder capital to be capital of the participants' fund in any meaningful sense, it must be possible for *qard* to be able to absorb losses permanently – that is, it must be forfeited if necessary.<sup>40</sup> A key regulatory challenge is to determine when that point arises. Where a market is characterised by persistent deficits in participants' funds and apparently permanent *qard*, the question may arise as to whether that business is still *takāful*. The willingness of some market participants to make such almost permanent transfers could have the practical impact of preventing other market participants accumulating capital in the participants' funds, due to price competition.

Regulators also have to consider whether the use of *qard* affects the performance metrics of an operation, a matter which depends critically on how those metrics are determined. In extreme cases, provision of *qard* could be used to support payment of fees to the operator, such that an operator could register profits funded in effect by deficits in the participants' fund. The accounting framework may provide for write-down of the *qard* asset in the operators' fund (on the grounds of impairment), negating those profits, but if it does not, shareholders and regulators could receive a misleading impression of the financial position of the operation, with both funds seemingly covered by adequate capital but in fact using the same capital twice as the shareholders' fund is only solvent if the *qard* is treated as a recoverable asset. The shareholders' fund would be in effect recognising future surpluses of

40 It is a separate Shari'ah question as to whether forfeiture is in fact justifiable, whatever the regulatory position, as compensation due to participants for mismanagement by the operator. It may be debated, for example, whether deficit arises as a result of lack of due care in pricing of the business, or failure to manage conflict of interest. Both the contribution (premium) payable by the participant and the amount taken as fee by the operator are determined by the operator. While the inherent volatility of much *takāful* business means that even a rigorous pricing process paying due attention to past performance and known and emerging risks will not necessarily result in surplus, a lack of attention to these matters would impede the identification of problems and the implementation of remedial action, and might be considered mismanagement. ICPs and IFSB standards, and often also national frameworks, set out a requirement for professional actuarial expertise in determining and monitoring pricing in insurance. With regard to the fee, an excessive reward for the operator compared to costs borne, or failure to manage costs, might also be argued to be mismanagement.

the participants' fund on its balance sheet as *qard* receivable, surpluses that have not been earned and might never be. Whether such issues become problems in a *takāful* market will depend to some extent on whether the regulatory framework contains incentives to use *qard* in this manner as permanent cover for liabilities, rather than as support for underwriting deficits to be utilised on a temporary basis only.

### ***Differential Interpretation in Sharī'ah***

Diversity in Islam is reflected in different understandings of Sharī'ah, noticeable in debate between practitioners from different schools of thought and different areas. A lack of uniformity is inimical to cross-border activity; however, imposition of uniformity is hardly practicable – it is difficult to form consensus on sincerely held but opposing understandings of the requirements of Sharī'ah on matters such as participation in surplus or the validity of profit commissions.

At the national level, the options available to policymakers depend critically on the wider environment, and in particular whether a national authority is available to provide binding rulings on the understanding of Sharī'ah as regards particular points. If such an authority exists, the regulatory authorities may require *takāful* operators to follow its rulings (and the regulator may indeed be associated with such an authority). In these cases, national consistency is advanced. Where there is no such authority, regulators may be reluctant to put themselves in a position of acting as the national interpretative authority for financial services, and instead require operations to maintain effective systems by which to reach their own conclusions. The reliance placed on Sharī'ah governance systems by operators in this case is even greater, as the governance has to cover the making of rulings, potentially on major points, as well as the policing of compliance.

### ***The Problem of Recovering Operations***

The case was referred to above, where a participants' fund has a persistent deficiency of funds. In conventional insurance, recapitalisation of the insurer can restore the economic strength of the institution. Due to the segregation of funds in *takāful*, the position is more complicated. The deficiency in the participants' fund is not eliminated, even if the *takāful* operator raises more funds, making it more capable of providing *qard*. The possibility of resolving a deficiency in the participants' fund by making a gift from the shareholders' fund is of course present, but a gift is voluntary. Regulators have to consider whether to require forfeiture of *qard* in a recovering operation, or other measures such as, for example, limiting the ability of the company to pay dividends to its shareholders while the participants' fund is in deficit.

Increasingly, insurance companies are being required to make contingency plans for adverse circumstances, to enable rapid management action if events occur, along lines that have

already been planned, approved and tested. A major objective of such recovery planning is to reduce the uncertainty that is attendant on a financial institution whose business model has proven unsuccessful, and to restore consumer confidence quickly. In *takāful*, the range of events that could occur, and the risks to which the entity is exposed, is more complex, as adverse events might hit only the operators' fund or only the participants' fund, and while a conventional insurer might be able to take a holistic view and benefit from diversification to ride out the storm, this is not possible for *takāful* due to the strict segregation of funds. *Qard* also has a potential role to play in recovering *takāful* operations. The recovery planning of a *takāful* operation requires an additional level of granularity compared to a conventional insurer.

## Dealing with Failed Operations

Insolvency of insurance companies presents particular problems due to the public interest in maintaining insurance as a protection and savings mechanism, and consequently many countries have insolvency arrangements for insurers that seek to pass on the business as a going concern prior to winding the company up, and solvency requirements that force a failing enterprise to go into run-off while there is still enough capital to pay the claims. In the Insurance Core Principles, ICP 12 sets out some basic principles, but highlights the influence of national laws on insolvency (e.g. rules that may give precedence to certain creditors).

In *takāful*, because of the segregation of funds between operator and participants, it is possible that only one part of the entity fails (e.g. a participants' fund may become unsustainable). The extent to which national insolvency law can override the segregation of funds, appropriating surplus in one fund to meet deficits in another, or treating *qard* as subordinated, is likely to be highly dependent on national insolvency law that was not drafted with *takāful* in mind. It is a challenge for policymakers of *takāful* companies to identify what insolvency requirements apply, and what modifications are necessary for *takāful*, and to set intervention levels such that insolvency is controlled.

Many jurisdictions have arrangements for compensation for customers of financial services firms who lose as a consequence of insolvency of those firms. The status of deposit insurance or policy protection schemes in the context of Sharī'ah raises complicated questions.

## *Takāful* Windows

Policymakers in some jurisdictions choose to permit the operation of Islamic "windows" in conventional insurance companies, ring-fenced operations operated on a *takāful* basis but reliant on the conventional insurer for provision of capital to absorb any deficit suffered

by the window. Windows are not permitted in all jurisdictions, and one model has been to permit the use of windows initially and then to phase them out as *takāful* operations achieve sufficient scale to stand on their own. Whether windows should be permitted, and if so whether (and when) to phase them out, are policy decisions for those responsible for making policy, requiring considerations of practicality as well as Sharī'ah (though not all policymakers will consider Sharī'ah as within their remit, particularly those where Islamic finance is a small component of a generally conventional system).

Where national policy does permit the operation of windows, this may facilitate provision of insurance on a *takāful* basis for risks characterised by size and volatility, to an extent not previously available, as the windows have access to the capital of their host companies. Recent initiatives in the London market provide an opportunity for placement of large commercial risks at least partially on a *takāful* basis, segregated from conventional operations.

## Conclusion

Islamic financial services are different from conventional ones, but they operate in the same market, competing and interacting with conventional financial services in such a way that, in at least the vast majority of countries, distress in the conventional sector can affect the Islamic financial sector, and vice versa. The proposition that the global financial services standards should not apply to *takāful*, or that a parallel set of standards can be developed independently for this sector, appears likely to result in arbitrage. In countries where only Islamic finance operates, policymakers have to consider the possibility of market failure, and the possibility of propagation of distress within the Islamic financial sector, in a similar manner to that in conventional economies.

Global convergence in financial regulation, and erosion of differences between national frameworks, at least in prudential regulation, are facts of life. The impetus is for effective cooperation, rather than cloning particular market models, and global standards leave room for accommodation to the needs of different sectors and different jurisdictions. Where they do not seem to, it seems appropriate to raise constructive challenge, to allow recognition of idiosyncracies of particular markets within the framework of the principles. The need to flex the framework to reflect the specificities of *takāful* as against conventional insurance, as well as more generally for characteristics of different markets, is recognised. There will inevitably be resistance, since global standard setters are aware of the risks of a race to the bottom. There is a balance to strike between national flexibility and adherence to broadly articulated principles, and the goal is outcomes that are comparable.

The work of the IFSB is illustrative of what may be achieved by working within, rather than against, the framework of global standards for financial services regulation, highlighting what needs to be done additionally or differently, to promote comparable outcomes in terms of consumer protection and financial stability. The aim of a coherent approach across jurisdictions, to minimise opportunities for arbitrage, is a work in progress for global standard setters for insurance in particular, so it should be no surprise that debate continues on the appropriate modes of regulation for *takāful*.

By comparison with prudential regulation, conduct regulation is a matter usually reflecting national standards rather than (yet, at any rate) international initiatives. However, particularly in a mixed economy, a claim to Sharī'ah compliance is a conduct issue that needs to be backed by credible governance. Some economies also have a history of miss-selling incidents that need to be approached with care. In this context, making surplus distribution a selling point is hazardous, particularly if the fund into which a policy is to be sold has *qarḍ* to repay. It is the author's view that an expectation of surplus distribution hinders the accumulation of capital in *takāful* operations, and makes failure due to adverse selection more likely than it would be if surplus was simply retained and contribution rates managed. If this is correct, the practice of surplus distribution has been a mistake.

Some areas of insurance regulation are as yet untested in the context of *takāful*. In particular, the relevant rights and obligations where a deficiency in the participants' fund cannot be corrected are fraught with difficulty, as in such situations the shareholders must effectively forfeit *qarḍ* they have given. Any attempt to do otherwise would be incompatible with recognising *qarḍ* as capital of the participants' fund, something that is essential if *takāful* is to compete in mixed economies and represent a viable alternative to conventional insurance.

Lastly, although much *takāful* operates on a basis of risk transfer between the participant and the fund (rendered acceptable by the mutual principle underlying the operation), with shareholder capital providing cover for volatility, policymakers looking to improve financial inclusion may consider that a risk-sharing model, which could be subject to less onerous regulation as to capital adequacy, can be applied for operations of low volatility and manageable impact of failure.





# CHAPTER 3: THE ROLE OF *MICROTAKĀFUL* IN FINANCIAL INCLUSION: THE FOUNDATIONAL CLAIMS OF INSURANCE IN ISLAM

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**Alberto Brugnoni**

## **Introduction**

In a world where 1% of the population owns as much wealth as the rest of the world combined, the richest 62 people own as much as the poorest half of the global population (OXFAM International, 2016), and 11% of the world population (or 800 million people) live below the extreme poverty line, set by the World Bank at USD 1.90 per day (World Bank, 2016), the most sought-after commodity is neither food staples nor water but the sort of empowerment that lifts people, whatever their religion or ethnicity, out of poverty and gives them a chance of reaching financial self-sustainability. This empowerment is provided by Islamic economics theory, the axioms and values of which propose an ethical system of finance based on the two ontological and epistemological sources of Islam: the Qur'ān and the hadiths. Its foundational claims are social justice, poverty alleviation and prevention of exploitation, while, at the same time, emphasising needs fulfilment and wealth redistribution across all sectors of society.

Unfortunately, a reality check shows that a chasm divides the theory and the practice. On the one hand, most of the members of the Ummah live in low-income or lower-middle-income countries: at least 600 million of them live in the poorest 10 Muslim countries; 80% of people living in the Middle East don't have access to formal financial services (World Bank, 2015);<sup>41</sup> and the MENA region continues to show, with a hefty 30%, the highest youth unemployment rates in the world (ILO, 2015). Furthermore, only six Muslim countries score "very high" on the Human Development Index (United Nations, 2014), and 40% of the Muslim populations, mostly female, are illiterate (OIC, 2015).<sup>42</sup> On the other hand, a tiny fraction of Muslims live in Qatar, Brunei Darussalam, Kuwait, United Arab Emirates, Saudi Arabia and Bahrain, six of the richest countries of the world (Global Finance, 2015),<sup>43</sup> with accumulated assets worth trillions of dollars. In the middle, lie equalisation tools – such as the compulsory *zakaṭ* and the quasi-compulsory *ṣadaqah* – that are meant to effectively redistribute wealth but that are failing, for whatever reasons, to do so.

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41 Middle East includes: Djibouti, Arab Republic of Egypt, Iraq, Jordan, Lebanon, West Bank and Gaza, Republic of Yemen.

42 The Islamic Educational, Scientific and Cultural Organization (ISESCO) assesses illiteracy rates in the Muslim world at 40% percent among males and 65% among females, with rural areas lagging behind urban areas by over 10%.

43 Gross domestic product (GDP) for 2015 is based on purchasing power parity (PPP) per capita.

Islamic microfinance is specifically conceived to fill the chasm between the haves and the have-nots by reaching out to those, the economically and socially underprivileged, who have been excluded from the formal financial sector. It consists of a number of bespoke modes of financing designed to help the poor to access funds in a Sharī'ah-compliant way, grow their businesses, and lift them above the poverty line. However, unwarranted events such as illness, death, fire or theft may cause setbacks leading to the non-performance of the financial obligations they have incurred. Indeed, the fragile ecosystem in which the poor live makes these unexpected events unmanageable most of the time and non-performance highly probable. This, in turn, creates an environment of doubt about the long-term sustainability of the microfinance model, and makes the funders of institutions dedicated to this financing wary of stepping into this business, thus preventing microfinance from unleashing its enormous potential.

This is where *microtakāful* plays a strategic role. The implementation of micro risk-mitigating instruments would enable the poor to set out contingency plans that strengthen their ecosystem, allow them to fulfil – even in the face of unwarranted events – their financial obligations and let them carry on their business. Besides giving the poor peace of mind and the benefits of insurance coverage, micropolicies provide them with the needed creditworthiness that facilitates access to Islamic microfinancing. At the same time, the Islamic microfinance institutions will find comfort in selling their products at a much lower risk. By reducing, in one stroke, the financial risk of the creditor/investor, and the vulnerability of the business of the debtor/investee, the endless vicious circle will end. *Microtakāful* policies may hold the key to the long-term sustainability of the Islamic microfinance model and help foster Islamic values.

## The Foundational Claims of *Takāful*

Nowhere do these values hold more true than in insurance activities. Indeed, Islam does not conceive of them as a self-contained, profit-oriented and money-making endeavour, nor as a way to create wealth. Rather, it envisages them as an essential tool for cementing, through solidarity and mutual protection, a social order based on the peace of mind of each member of society, as required by the Qur'ān (5:2): “And help one another in righteousness and piety and do not help one another in evil deeds and enmity.” The achievement of this state of mind – indeed, a key component of the social fabric – is the result of the preservation of each member of society's tradition (*dīn*), life (*nafs*), progeny (*nasl*), intellect (*'aql*) and property (*māl*) through a communal effort, as stated by the Qur'an (3:103): “And hold fast, all together, by the rope which Allah (stretches out for you), and be not divided among yourselves.” Furthermore, this effort, though communal, is in fact an obligation that falls upon each individual Muslim (*fard 'ayn*) as highlighted very clearly by the Prophet Muhammad (PBUH) on endless occasions: “You see the believers as regards their being

merciful among themselves, showing love among themselves and being kind among themselves, resembling one body, so that, if any part of the body is not well, then the whole body shares the sleeplessness and fever with this" (Sahīh Al-Bukhārī, 1985, vol. 8, *The Book of Good Manners*, p. 26); "A faithful believer to a faithful believer is like the bricks of a wall, enforcing each other" (Sahīh Al-Bukhārī, 1985, vol. 1, *The Book of Prayer*, p. 278); "A Muslim is a brother of another Muslim, so he should not oppress him, nor should he hand him over to an oppressor. Whoever fulfilled the needs of his brother, Allah will fulfil his needs; whoever brought his (Muslim) brother out of a discomfort, Allah will bring him out of the discomforts of the Day of Resurrection, and whoever screened a Muslim, Allah will screen him on the Day of Resurrection" (Sahīh Al-Bukhārī, 1985, vol. 3, *The Book of Oppressions*, p. 373).

In the contemporary discourse of Islamic economics, these divine-guided enjoinders have translated into the more mundane insurance parlance terms of "cooperation" (*ta'āwun*), as opposed to "shareholding", "donation" (*tabarru'*) as opposed to "premium", "risk sharing" instead of "risk transferring", and "common interest" (*maslaha 'amma*) rather than "personal gain". Operationally, these terms have coalesced into an ideal venture called *takāful*, where members of a not-for-profit cooperative bind themselves together through a contract of mutual guarantee. As such, the philosophy of *takāful* shares the foundational claims of the conventional cooperatives – with added restrictions on investments and more flexibility on capital formation – to such an extent that the conventional cooperative and mutual insurance schemes investing in Islamic-compliant products are de facto accepted under Islamic law.

The successful implementation of this philosophy in the real world necessitates, first, a bottom-up approach where members of an affinity group pool together their resources for mutual covering. This process of capital formation is quite similar to that experienced by their conventional cousins in 19th-century Europe. But while they had several decades at their disposal to slowly grow, root their business in the local communities, and find a viable balance between expected claims and available resources, in the contemporary world, regulatory and solvency requirements aiming to protect the consumer are much more stringent and don't allow much flexibility to the *takāful* proponents. Second, it necessitates the steadfast promotion of the values and principles on which the proposition itself is based, without losing sight of the foundational claims that bind its members together. Indeed, the successful promotion of mutuals in 19th-century Europe was made possible by a society that shared their principles and was imbued with the values of the social doctrine of the Church or, for that matter, with the social ideology of the trade unions.

To satisfy modern-age urgency for regulatory capital requirements and to organically grow the business while, at the same time, upholding *takāful* values, Islamic economics has, unlike its conventional predecessors, two readily-available and highly efficient tools

embedded in its very fabric – namely, *zakat/sadaqah* and *waqf*. However, after the *fatwā* issued in 1985 by the *fiqh* academy of the Organisation of Islamic Cooperation (OIC), the rapid commercialisation of *takāful*, and the ensuing flocking of investors in search of returns, has pushed the industry to adopt a different and pragmatic approach, to blindly adhere to the principles of neo-classical economics, and to raise regulatory capital through the establishment of a for-profit pool. This so-called *tijāri* approach has resulted in a hybrid structure between a mutual, where the principles of *ta’āwun* and *tabarru’* lie in the participants’ pool, and a proprietary entity, thirsty for quarterly profits, that has relegated the importance of social dimension and failed to internalise social justice into its own operational functions. By doing so, the Islamic insurance industry has weakened the entire social justice discourse of Islamic economics and, above all, has not made any significant contribution to the betterment of the lives of common individuals, Muslim and non-Muslim alike. These developments appear to be at loggerheads with the original spirit of *takāful* and to contradict its foundational claims. These contradictions come to light particularly in the *microtakāful* proposition and are thwarting its development.

### Microdelivery in Islam and *Microtakāful* Providers

Whereas in the past poverty was measured solely by per-capita income, nowadays deprivation of health, education, food, liberty and opportunities all contribute, directly or indirectly, to the appraisal of the Human Development Index (HDI). The access to insurance services is widely recognised as an effective way to contribute to the improvement of the HDI by reducing the vulnerability of the poor to the impact of disease, theft, disability and other hazards. But it also is a way to use savings and credit facilities more productively for income-generating opportunities. This stimulates outside investments, allowing for the achievement of sustainable growth and the attainment of a better standard of living. In turn, the investment of savings that do not need to be earmarked for unexpected events in children’s education leads to better health and better income-earning potential, as well as population control. Furthermore, the mitigation of the impact of personal and national calamities on the build-up of assets provides escape from the vicious circle of poverty that engulfs each new generation and protects those that have risen above the poverty level against unforeseen events that may cause them to fall into poverty again. In a word, insurance services provide security to the poor where none is available from the state, facilitate self-sufficiency, and empower people to build for their own future.

These insurance services are delivered to the poor through the so-called micro policies – the word “micro” referring to the level of society where the interaction takes place and not to some special features of the policies themselves. Indeed, these *microtakāful* policies are not conceptually different from the *takāful* standard policies targeting the well-to-do members of society. They partake with them of a risk-sharing mechanism in which

contributions, calculated in proportion to the likelihood and cost of the relevant risks, are paid by all members of the insurance scheme to a pool that, in turn, is used to reimburse those members of the scheme who incur losses. What is different is the socio-economic profile of the policyholders. They are the low-income men and women working in the informal economy that share limited access to the basic requirements of insurability, such as health care, proper sewage and clean water. They lack bank accounts – with the ensuing need to pay premiums in cash, potentially increasing the cost of collection, and assets – with the possibility that one single loss event could spell disaster to the policyholder and his or her family. Furthermore, the monthly fluctuation of disposable income and the likely dependence on loans and government handouts to make ends meet may affect the ability to maintain regular contributions, as it is well known that to become a policyholder an individual must have the ability to save and earn a regular income. Finally, the lack of experience with financial services makes such people susceptible to miscommunication, leading to misunderstanding.

*Microtakāful* policies are originated and distributed mainly by three categories of players that are subject to different degrees of regulation. First are the *takāful* operators themselves. These are commercial, profit-oriented and formal institutions, usually joint stock companies, strictly regulated in their own jurisdictions. In their offering of micro policies, they apply the same internationally recognised governance principles applied to their standard policies though they may be flexible in their underwriting requirements and use the proportional approach.<sup>44</sup> These principles include: a comprehensive framework in which the independence and integrity of each organ of governance is well defined and preserved; an appropriate code of ethics and conduct to be complied with; a governance structure that represents the rights and interests of all stakeholders; the provision of all relevant information to the *microtakāful* participants; appropriate mechanisms to sustain the solvency of the undertakings; the implementation of a sound investment strategy; and prudent management of the assets and liabilities.

The second category of player includes formal institutions whose main sources of income are not *takāful* activities and that offer *microtakāful* policies as side products. These institutions are regulated, often less stringently, under laws other than the *takāful*/insurance law in their own jurisdictions; they also may receive monetary assistance in the form of government subsidies or charitable donations. They range from funeral societies or associations, to cooperatives under the cooperatives' authority, mutual under the mutual authority or other law, health insurance programmes or health providers under health authorities, insurance offered through post offices under the postal authority, and non-governmental organisations, to many other types of charity-driven institutions such as *zakah* and *ṣadaqah* collectors. They

44 The proportionality principle aims to justify (a) simpler and less burdensome ways of meeting requirements for low-risk activities, and (b) more sophisticated methods and techniques for more complex risk situations.

may also include government agencies that launch nationwide initiatives, and microfinance institutions that bundle together *microtakāful* products to cover the loans provided.

The final category of player includes the grassroots informal groups or community associations, such as funeral parlours or unregistered death benefit associations that are created to provide coverage to their own members. Though these initiatives are commendable, it is assumed that informal *takāful* is undesirable and that all *takāful* activities should be conducted by licensed entities. As these undertakings are spontaneous and totally unregulated, they lack a Sharī'ah governance system, commensurate and proportionate with their size and the simplicity of their business, to ensure the compliance of their structures and processes.

The providers of *microtakāful* are faced with an array of issues that prevent them scaling their activities and widening the reach of their proposition. Some of the key issues are discussed below.

## Capital and the Use of *Zakat* Funds

The first and most important issue besetting the blossoming of *microtakāful* is the need to have sufficient regulatory capital from the very beginning of the operations. The *tijāri* approach chosen by the industry makes *microtakāful*, in spite of its hybrid nature, a de facto proprietorship structure where the shareholders, by deploying capital in the operator's account, promote and own the business and require the maximisation of returns on the capital invested. This operator's account – connected, through the *muḍārabah* and/or *wakālah* contracts, to the participants' pool that pays claims and the *retakāful* contributions – is a for-profit endeavour set up to run the business and be profitable. It finances solvency margins, pays potential *qarḍ* in times of distress, and covers expenses overruns. In exchange, it receives from the participants' pool *wakālah* fees and/or *muḍārabah* profits with which it pays dividends to its shareholders. Within this framework, the operator needs to manage the risk–return trade-off and produce steady and sizeable returns. Hence, it has to address issues such as the critical size, expenses loadings versus expenses incurred, underwriting profitably, unit return per capital invested, etc. that collide with the ecosystem of the poor.

Furthermore, the poor operate in a mini-economy in which all activities occur in small amounts; as a consequence, the relative transaction costs of underwriting policies tend to be high and institutions operating the *tijāri* approach find it difficult to strike a balance between policies whose premium is affordable by the poor and satisfaction of the shareholders' expectations. It has been recommended that the implementation of very simple protection schemes at an affordable premium may help the operator to be competitive in the market without being detrimental to the stability and soundness of its financial conditions. But this

would very much limit the scope and effectiveness of the micro policies. It has also been suggested that the shareholders should venture into *microtakāful* for the “right reasons”, take a long-term, capital investment approach, and be willing to substitute some of the expected financial returns with social objectives. But this is pretty much outside the scope of their neo-classical approach.

A viable solution to this impasse would be to phase out the *tijārī* solution and to tap into the available pools of *zakat* funds for financing of the operator’s account. This *ta’āwuni* approach – which is aligned more, through the tenets of the Islamic economic system, with the needs of the community than with those of the individual – removes the urge for quarterly profits from the operator’s account while making possible the satisfaction of solvency margin requirements and the financing of the *qarḍ*. It will also help sustainability, as in the initial years most insurers incur a loss from acquiring and servicing customers. The participants’ pool will keep paying the claims and the *retakāful* contributions, whereas administrative functions could be outsourced to a third party. Abundant resources are potentially available to make this approach feasible, but a strategic organisational effort is needed as contemporary *zakat* institutions appear to be weak and ineffective both in collection and distribution. For instance, the Islamic Development Bank (IDB) estimates the potential flow of *zakat* originating from the OIC countries at USD 6 trillion and GDP at USD 200 billion per annum,<sup>45</sup> while Sultan Nazrin Shah (*Sun Daily*, 2016) estimates the world annual flow at USD 600 billion.

The question arises whether it is possible to use *zakat* funds for this purpose. *Zakat*<sup>46</sup> – literally “to grow through purification” – is an act of monetary worship that requires any Muslim who possesses wealth equal to or exceeding a laid-down amount to give away a portion of it. The enforcement of this act of worship lies deep in the inner conscience of the believer who, by cleaning his or her soul from stinginess and niggardliness, discharges a personal obligation towards God. Aside from its spiritual objectives, *zakat* serves as a basic system for the implementation of socio-economic justice by transferring a certain portion of the income from the haves to the have-nots, including the wealthy under stress, new entrants to the fold of Islam, and bona fide insolvent debtors.<sup>47</sup> At the macroeconomic level, it helps the redistribution of wealth either by direct disbursement to the vulnerable and the poor or by providing them with education, health facilities and other social services. At the microeconomic level, it provides a powerful incentive to invest wealth rather than leaving it idle or unused. It promotes economic growth and productivity through the circulation of

45 Author’s collection and extrapolations from IDB data.

46 It is to be remembered that the Qur’an also uses the word “*sadaqah*” to imply *zakat*. It was later that the jurists made a technical distinction between *sadaqah* (donation) and *zakat* (financial obligation).

47 Qur’an (9:60) identifies eight categories of beneficiaries of *zakat*: “*Al-sadaqāt* are only for the poor (*fuqarā*), the destitute (*masākin*), those employed to collect (the funds); to attract the hearts of those who have been inclined (toward Islam); (to free) the captives; for those in debt; for Allah’s cause; for the wayfarer.”



wealth; meets the consumption demand of the poor; checks the hoarding of idle money; and finances projects such as education, medical care and social welfare.

The debate on the hows and whys of the distribution of *zakaat* to its beneficiaries has seen the classical jurists discussing them in the context of the socio-economic conditions of their time. Though their interpretations varied and included the most literal and restrictive ones, even in the 13th century Al-Nawawī stated: “The purpose of the distribution of *zakaat* is to make the poor and needy reach their sufficiency. A craftsman would be given an amount sufficient to buy tools and equipment that allow him to work and gain his sustenance ... Farmers would be given farming land or portions thereof that would be sufficient to gain them sufficiency of sustenance” (Al-Qarḍāwī, 1969, vol. II, p. 12). He based his statement on the well-known ‘Umar insistence on giving the poor an amount that would be sufficient for them for rest of their lives. The effort of *ijtihād* has continued in modern times and focused on whether *zakaat* funds can be utilised in financing development projects and trade ventures, and whether their disbursements can be expanded beyond the current needs of the recipients. A group of jurists, we may call them “literalists”, maintain a restrictive approach and state that the *zakaat* funds must be disbursed immediately to the recipients lest the principle of *tamlīk* (transference of private ownership to the poor) is contravened and the designated class of beneficiaries blurred (Zulfiqar, 2011, p. 193). Nevertheless, even they make some exceptions that include the financing of Islamic education, vocational training, agriculture and cottage industries, simple fixed assets for small utility and trade projects, working capital for craftsmen, low-cost-housing and medical facilities (Mohammad Qutub and Abu Zahrah, cited in Mek Wok Mahmud and Sayed Sikandar Shah (Haneef), 2009, p. 7).

Another group of jurists, which is actually the majority, takes into account today’s conditions and is comfortable with the use of *zakaat* to provide social services to the poor, such as hospitals and schools, but also factories which create employment opportunities. They base their view on the fact that *tamlīk* is not a precondition for spending on the beneficiaries, as feeding and clothing the poor from the *zakatable* income of the *zakaat* payer amounts to fulfilment of his or her *zakaat* obligations. They also maintain that its disbursement does not have to be prompt, as *zakaat* is generally classified as an obligation with an extended due time. Lastly, they assert that this is not a blameworthy (*madmumah*) innovation, as it benefits the recipients and does not harm them; it is a praiseworthy (*mahmudah*) innovation that can be initiated on financial matters. Accordingly, instead of giving the poor recipients their share in a lump sum, they could be given a monthly stipend from the proceeds of the *zakaat* investment. The settling argument in favour of this interpretation is the Prophet’s permission to a group of people from ‘Uraynah to drink milk of the *zakaat* camels. This implies that other uses of the camels such as riding and leasing would also be permissible.



By extension, this interpretation allows the use of *zakat* funds for financing, including, in the case of the *microtakāful* industry, regulatory capital that could be amassed and increased annually through the channelling of *zakat* funds to the operator's pool. The paid-up capital would then be distributed as share certificates to the *zakat* beneficiaries, making the poor pro-rata owners of the operator's pool: this would satisfy the juristic conditions of *tamlīk* and also fulfils the condition of immediacy of *zakat* disbursement. Finally, the poor could satisfy their pressing consumption needs, if any, as these certificates would be marketable. An additional use of *zakat* funds could be the payment of premiums in the event that the granting of microfinancing was conditional on the underwriting of *microtakāful* policies. This use is supported by many jurisprudential rules that allow the use of *zakat* funds to benefit the recipients by providing them with working capital or the tools of their profession.

## Capital and the Use of *Waqf* Funds

A second readily-available tool able to provide the starting capital required by the regulator and that fully belongs to the Islamic tradition is the *waqf* (endowment). If properly operated, it could well substitute for government-funded schemes where contributions are provided as subsidies.<sup>48</sup> Highly flexible, *waqf* has proved itself instrumental for the implementation of the social justice discourse propounded by Islamic economics.<sup>49</sup> In the course of history, it has been set up to sustain almost every Sharī'ah-approved activity, ranging from interest-free financing and debt relief to the building of infrastructure and public utilities;<sup>50</sup> from fostering health initiatives, including hospitals and veterinary clinics, to the educational sector, including universities and students' vacation homes. Unfortunately, in contemporary times the concept of *waqf* has degenerated, both in theory and in practice, and is in need of rejuvenation by a collective effort so that it can again play its natural role in social development. As *waqf* is based on *ijtihādi* laws, more creativity should be exercised to allow the undertaking of those operational changes that might enhance its productivity and efficiency.

With regard to *microtakāful*, the possibility of replacing obsolete and dilapidated *waqf* properties with assets accepted for regulatory purposes should be thoroughly explored. This would open up the use of *waqf* properties, valued at between USD 100 billion and

48 An example is the "Microfinance Insurance Fund" in Sudan implemented by Shiekan, nine commercial and microfinance banks, and the Central Bank of Sudan. In this scheme, the bank is the policyholder and pays the premiums of its covered clients; Shiekan is the insurer and receives the premiums; and the client repays to the bank the amount of the premium in instalments.

49 At the beginning of the 20th century in Palestine, 233 *waqf* deeds were recorded, owning 890 properties, compared to 92 private ownership deeds with 108 properties. Al-Quds had 64 operating schools supported by *waqf*, more than the number of mosques (Ahmed, 2012).

50 Suffice to say that in Ottoman Turkey, plagued by budget constraints, more than 35,000 private foundations funded public-works projects and municipal services, from water systems and schools to hospitals, bridges and roads. At the dissolution of the empire, three-quarters of the land and buildings in some Turkish towns were *waqf* (Nizamoglu, 2012).

USD 1,000 billion by the IDB, to launch *microtakāful* operations across the globe (Mahir Idrissi, 2014). The *waqf* pools created in this way would be managed by trustees and used to satisfy solvency margin requirements and finance any *qard*. They would also receive surpluses from the participants' pool that, in turn, would be charged with the payment of expenses, fees to third-party administrators, claims and *retakāful* contributions. The creation of *waqfs* dedicated to specific policyholders' funds and the use of cash *waqf*, a tool that lends itself particularly well to monthly, quarterly and annual cash contributions, should also be considered.

## Regulatory Issues

A second issue confronted by *microtakāful* providers is the regulatory framework enacted to protect insurers from financial instability and consumers from misleading selling practices. The existing rules, though praiseworthy and needed, are conceived to regulate the delivery of insurance services to the middle- and upper-income markets. When applied to low-income communities, they hinder the development of micro policies: the building up of hefty contingent reserves to meet excess claims makes their development uneconomical due to the small premiums and high risks involved and may result in unsustainable costs that impinge on their delivery to the end-users.

The nature of this market segment calls for more-flexible regulatory requirements that take into account the size, complexity and nature of the risks absorbed by the *microtakāful* institutions. The seven key features recommended by IFSB-11: *Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings* – namely, the total balance sheet approach, the separation of the solvency requirements of the two funds, the enforcement of stringent solvency control levels, the quality and suitability of solvency, the implementation of separate risk-adjusted computation for solvency requirements for undertakings, a sound risk management framework, and a full information disclosure – should be implemented using the principle of proportionality and recognising the unique nature of *microtakāful*, especially where the risks are geographically diversified. For example, the requirement to have two solvency control levels for each of the funds may be unwarranted.

An additional innovative way to deal with this issue could be the use of discretionary mutuals, where the benefits payable under the *microtakāful* policies are not explicitly guaranteed. Although the intention would be to pay full benefits, if funds are inadequate, benefit payouts are proportionately reduced to ensure sufficient funds to pay all claimants. The non-guaranteed nature of payouts should allow for much lower capital requirements, though it would call for strong internal corporate governance to protect the interests of all stakeholders. The Iddir, traditional Ethiopian informal life insurance providers, retain the

right to fluctuate claims payments and premiums in accordance with mortality rates.<sup>51</sup> In a more mature market, Capricorn Mutual offers a viable example. This Australian non-profit cooperative, regulated as a financial services provider but not by the Insurance Regulator, exercises discretion on membership admittance, scope and level of protections, but also on claims decisions. Benefits are not guaranteed: the board of directors, guided by the principles of fairness and justice, decides on the payment to be made on receipt of a claim.<sup>52</sup>

Another option worth exploring would be the use of deferred shares that allow mutuals to raise, in addition to retained earnings and debt, working capital through the issuance of members' investment shares. The *Mutuals' Deferred Shares Act 2015*, recently enacted in the UK, is intended to permit friendly societies and other mutual insurers to create a new form of tier 1 capital. This capital could also be used to finance business growth and new products.

Finally, in the *ta'awuni* proposition surpluses should automatically be earmarked as contributions to the *waqf* fund, thus allowing solvency capital to grow organically with the business.

## Product Design and Coverage

Product design and coverage are a third fundamental issue. The conundrum faced by the *microtakāful* industry is that products should be tailored to specific needs but, at the same time, be easy to understand and administer, and very reasonably priced. It is well-known that a significant portion of the expenses incurred by the insurer in writing a policy is fixed in nature; for micro policies, this may amount to a sizeable percentage of the premium. To keep the latter affordable to the end-users, *microtakāful* products are either very simple, with one fixed sum assured, no underwriting requirements, and simple claims procedures, or protection is restricted by an array of underwriting clauses, including age, size, value and causes of loss. In both cases, the effectiveness and scope of these micro policies is very much reduced.

A more flexible approach with the creation of bespoke products adapted to local circumstances would require a better understanding of the nature of the end-users through the development of updated actuarial tables and ad hoc mortality and morbidity data. This should go hand in hand with the proportionate application of the Insurance Core Principles, especially ICP 5: *Suitability of Persons* and ICP 7: *Corporate Governance*, and the running of profitability and comprehensive tests of products to ensure the sanctity of the operation.

51 Dejene Ared (2010), "The Iddir: An informal insurance arrangement in Ethiopia", *Savings and Development*, No. 1, pp. xxxiv, 53–72.

52 Capricorn Mutual, [www.capricornmutual.com](http://www.capricornmutual.com) (viewed 18 June 2016).

Another cost-efficient way would be the use of indexed insurance to cover natural disasters such as flood, drought, locusts, earthquake, etc. to which entire regions are exposed. If those risks are dealt with separately, the remaining individual risks would be much more manageable. Besides, since indexed insurance is not vulnerable to moral risk, a pool dedicated to it can certainly be subsidised by *zakaat*. The disadvantage of indexed insurance – namely, the triggering of a claim with no loss, and vice versa – can be reduced by the granting of the policy on a regional or communal basis.

The set of these measures would enable the *microtakāful* providers to extend their range of offering from simple products, such as credit life and disability for financing, to moderate products such as term life, to (perhaps) complex products such as annuities, endowments, property, loss or damage of equipment, livestock or other capital goods, and to highly complex products such as crop insurance and health.

## Additional Issues

Moral hazard is the risk that the insured will change his or her behaviour and increase the possibility of a claim. This is more likely in *microtakāful*, as the policyholder has little to lose and a lot to gain; for instance, he or she may be less likely to look after his or her health, property and spending patterns in the knowledge that insurance cover is available. In addition to the implementation of differential pricing to reflect different risks and claims experience, waiting periods, the exclusion of pre-existing conditions, co-payments and limited coverage, a sensible way to reduce the moral hazard would be the provision of insurance through partnerships with end-users' associations, including "natural associations" such as mosques, communities, villages or tribes. Akin to moral hazard is another risk: fraud. The poor are desperate to improve their standard of living and have greater opportunities for fraud in an informal environment. The *microtakāful* providers need an effective claims verification system, appropriate internal controls, and regular and credible financial reporting to give management the opportunity to identify fraudulent activities, although verifying beneficiaries, assessing incomes and collecting contributions in the informal sector is a problem in itself due to the lack of information and reluctance to declare.

An ever-present issue that represents additional costs and a further burden on the provider is the lack of education about insurance among the potential end-users. The bad image insurance has among the poor is compounded by the fact that the prospective policyholder may not be able to read, let alone understand, the terms and conditions, as limitations and exclusions are often unclear due to complex policy wordings. There is, indeed, a need to educate the poor on the concept of risk pooling, the coverage it provides, and the benefits of a protection that does not give immediate tangible benefits. The majority of the little disposable income of the poor is spent on life-cycle needs such as food, shelter, health

and education, with very little available for insurance and savings. Hence, there is a need to show the potential clients the importance of investing his or her savings in the cover for the long term but without trying to recuperate it through a claim or dropping out if there is no claim. Dropouts may occur when there is a downturn in the economy, adverse conditions in agriculture, misunderstanding of policies, changes in prices or service, lack of effective and focused communication, and other more pressing needs on clients' income. The responsibility for addressing the issue of consumers' education and awareness is shared by all stakeholders, from regulators to *microtakāful* providers to intermediaries, and is just as important as their technical know-how.

Due to the high levels of risks and volatility of the client base, the management of *microtakāful* requires a level of technical expertise greater than that needed by the standard *takāful*. In fact, in addition to adequate management information systems for accurate and timely policies processing and claims verification to ensure adequate controls and efficient payments, *microtakāful* needs a particularly strong actuarial support and market research to avoid over-exposure to high-risk policyholders when only a small percentage of the market is insured. The expertise to successfully price not only simple products but also complex-calculations products such as health and property is key to ensuring the long-term financial sustainability of the *microtakāful* schemes. The use of simplified calculations that place a dangerous reliance on clients' estimates of sufficient premiums is a dangerous approach that, without grasping risk management strategies or techniques, may lead to insolvency and leave the policyholders without any form of protection. This expertise is also needed to manage adverse selection<sup>53</sup> and enable the operator to reach a sufficiently large pool size of the right mix of risks to ensure that there are sufficient funds to pay claims. *Microtakāful* is a highly technical and costly business that requires qualified, skilled staff who are able to predict future costs and claims, invest reserves and surpluses to ensure that future liabilities are matched, operate each scheme efficiently, and empower local staff with the relevant knowledge and technology.

Distribution, marketing, communication and follow-up are the last, but certainly not the least, of the issues. Efficient intermediation is, indeed, at the heart of any *microtakāful* system: the poor ought to have easy access to micro policies in their fraternity, locality and workplaces through intermediary mechanisms that are cheap and reachable. It has been observed that the *microtakāful* industry mainly uses the agency channels, operating an expensive field force to which hefty commissions are paid and leaving narrow margins to justify their business model. Instead, all available channels of distribution should be exploited to cover the majority of the population: from small grocery stores to pawnshops, including, though

53 Adverse selection occurs when a significant portion of high-risk policyholders sign up to the insurance policy. If the policy is voluntary, those that are most likely to make a claim will be the first to sign up.

urban-centric, bancassurance. In this regard, new technologies, such as mobile phones and e-money, play a vital role in boosting outreach and limiting distribution costs. Microfinance banks, technology providers, telecom operators and branchless banking models are all potential game changers. To minimise distribution costs, the policies should “ride” on any existing commitment and be included in the loan repayment instalments, built into the price of fertilisers, etc. And whenever possible, the operator should implement group policies aimed at a specific group of individuals with common or shared characteristics with the use of community (one-for-all) rating. The constant communication with policyholders is a key requirement, as schemes may need to accommodate the earnings volatility and lower contributions of the self-employed and informal workers. It is also important that claims and process payments are verified quickly, due to the lack of other financial support available to the poor. Finally, frequency of payment should match the ability of the client and the financial needs of the organisation to pay claims and operating expenses.

## Conclusion

Although measures to reduce poverty and promote social mobility predominantly reside within the realm of structural economic policies and public social protection schemes, *microtakāful* products offer the end-users peace of mind from the knowledge that financial relief is available easily and in a timely manner if an adverse event unexpectedly occurs. In this sense, it looks very promising when it comes to facilitating financial inclusion and bringing the poor equity, stability and growth.

But to effectively contribute to the needs of the have-nots, *microtakāful* needs to be true to itself, to its foundational claims, and to its own economic ethos by making use of the traditionally and abundantly available resources of *zakat* and *waqfs*. The attempt to squeeze Shari’ah-based insurance principles into a neo-classical framework that is alien to the ecosystem where it wants to deploy its proposition is, for *microtakāful*, a non-starter from the beginning. It can be done only at the cost of compromising its own core values and will ultimately result in the failure of the proposition. In this sense, *microtakāful* is not for the faint-hearted: it needs vision, humility, and steadfast implementation of its principles. One can even venture to say that the success of *microtakāful* is a litmus test for the whole industry to come up with a system that reflects the values and principles of Islamic economics.

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## Appendix 3A: Index Insurance in *Microtakāful* and *Fiqh* Implications (A Commentary to Chapter 3)

Dr. Ludwig Stiftl

### Parametric trigger covers – the way forward in microfinance

The relation between demand and wealth (including substitutes for it like family networks) is rather obvious in *microtakāful*. Unlike in banking, where the microfinance institution pays out to the client before repayment becomes due, the buyers of *microtakāful* have to pay a premium first from their meager and unstable income. At the same time, their budgets are not only limited, but in their buying decisions insurance competes with very basic needs such as food or schooling. An economic price is thus most crucial. Thirdly, the minimal livelihood they possess needs to be protected at any cost, simply because it is already the minimum. It is for this reason that Dr. Brugnoli has rightly pointed out the importance of cost control.

The dilemma arises on the pricing side, since fixed costs (for e.g. risk evaluation) weigh a lot more calculated against the small sums in *microtakāful*. A possible tool to escape this dilemma at least for natural, e.g. weather related risk, to which rural populations are particularly exposed, are index based, parametric trigger products. Paying an indemnity just at the occurrence of a pre-defined amount of flood height or earthquake magnitude at a pre-defined place saves the costs of evaluation of losses and reduces fraud and to some extent anti-selection<sup>54</sup>. This kind of product comes with other weaknesses, though, and the problem is that it does not fit the mentioned wealth constraints due to the basis risk inherent to the system. We try to show this with a calculation based on the experimental numbers of a field experiment on index insurance demand in rural Ethiopia (Clarke and Kalani, 2012).

The experiment consisted in a setup of decisions proposed to the participants on whether to buy index-based or indemnity-based (conventional) insurance and whether to do that individually or in a group. The simple figures of expected wealth (minimum, maximum and average, i.e. variance and expected value) under six different levels of insurance cover (from 0 to 100% of the possible loss) are shown in the diagrams below<sup>55</sup>.

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54 Another aspect of index insurance is that it may reach the volumes where reinsurance is useful and required, in particular if it covers larger areas and/or is combined with a public private partnership with state authorities covering infrastructure values. Support of reinsurers on the technical side would be helpful, and the micro-retail business usually does not reach the economic scales for international reinsurers

55 Since we want to show only the principle, the more complicated group decision setups are not considered here.

In Table 1 which shows the situation of traditional indemnity insurance<sup>56</sup>, we see that with increasing insurance cover (from scenario F to A as in Clarke et al.'s original article) the possible maximum wealth decreases and the minimum increases<sup>57</sup> until, at the highest level of insurance cover (scenario A), all the risk is transferred, and maximum and minimum meet in the average point. The variance, as a measure of uncertainty, is zero in this point. The issue is just that the line in the middle, representing expected wealth also decreases quite steeply due to the premium payment. This trade-off between expected wealth and certainty is of course the very function of insurance and represents the price of it, but that particular steepness of decrease of expected wealth, which may be a good deal for a traditional buyer, can just be too costly for the micro-insurance clientele.

**Table 1: Reduction of Uncertainty by Increase of Insurance in the Traditional (Indemnity) Case**

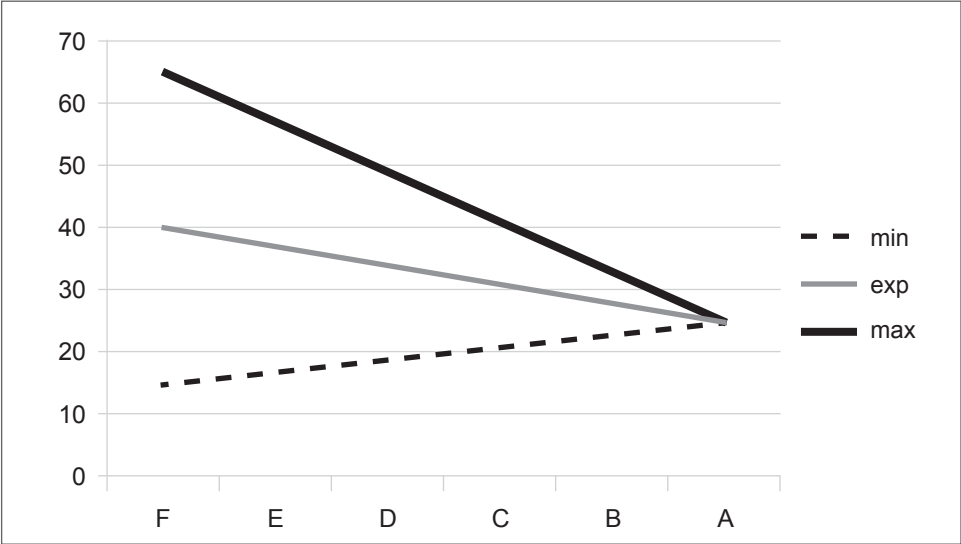


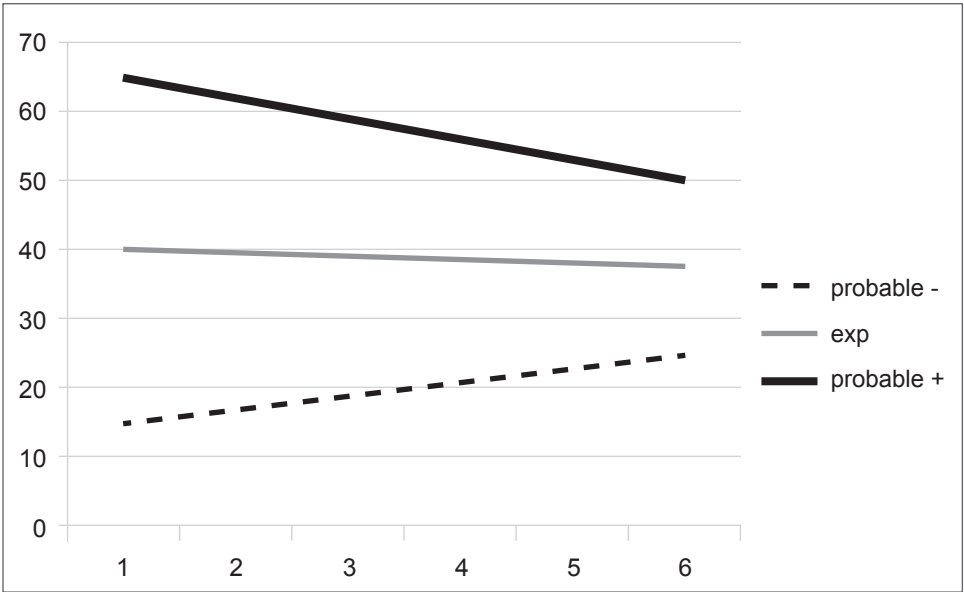
Table 2, on the other hand, shows the comparable curve for a weather-indexed product, again with increasing levels of cover from 1 to 6. Here, the curves of the most probable minimum and maximum wealth outcomes converge much more slowly and never fully meet, leaving a considerable amount of uncertainty. But in exchange, the expected wealth goes down at a much slower rate. That would look like a very good compromise for solving

<sup>56</sup> Table 1 and 2 show the maximum and minimum outcomes without probability weighting. The median is at the same time the expected value, since in this experimental setup the probability of positive and negative deviation is perfectly symmetric.

<sup>57</sup> The maximum wealth (at maximum risk) is represented under scenario F by not choosing any insurance cover and thus not paying any premium but luckily not suffering any loss. The corresponding minimum wealth also arises under F, namely if there is a loss. In this setup, the premium is actuarially favorable, since by paying 8 Birr of premium, the possible loss is reduced by 10 Birr.

the issue of price constraints in micro-insurance, were there not the less probable but still considerable<sup>58</sup> side effect of basis risk, which is shown in Table 3.

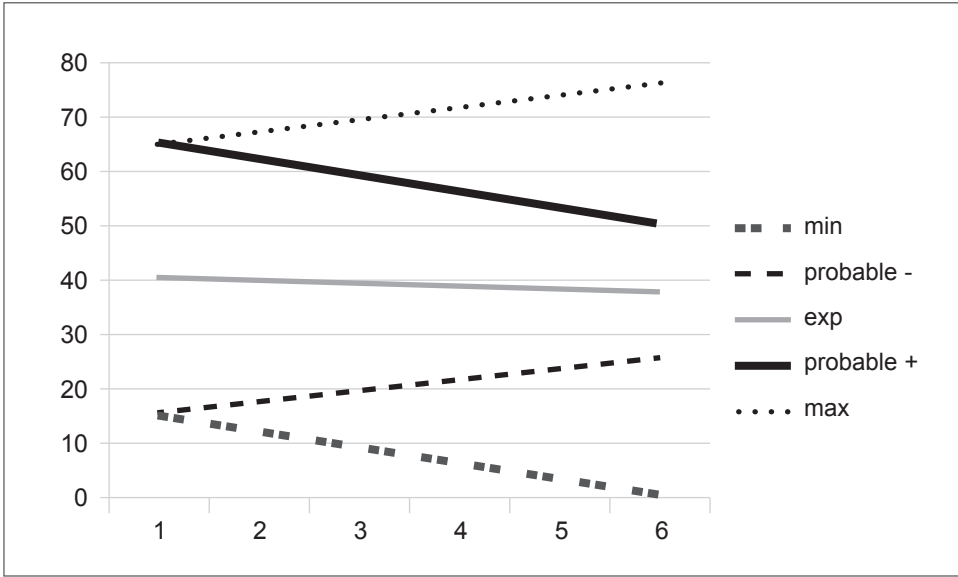
**Table 2: Reduction of Uncertainty by Increase of Insurance Cover in the Index Case**



Since the real losses are not gauged in index insurance, but just the triggering of the insured parameter, it can occur that an insured suffers a loss but does not get a pay-out, since the cover was not triggered. The corresponding positive windfall-effect arises, when the insured gets a pay-out without actually having suffered a loss (see the dotted and double-dash lines respectively in table 3). Still, like in indemnity insurance, the overall variance goes down (because there is more probability weighting behind the converging lines than behind the diverging ones of basis risk and windfall). But, unlike in the indemnity example, the (un-weighted) minimum wealth can be lower at a higher level of insurance than with less or without insurance. This is exactly the issue of basis risk which has to be tackled in micro-insurance, since the micro-insurance clientele cannot afford to take the chance of ending up with less than the minimum wealth, no matter how unlikely this outcome is.

<sup>58</sup> In Clarke's example, the probable outcome was calculated at a probability of 3/8 for both minimum and maximum while the basis risk accounted for 1/8 of probability, as did the windfall profit, the positive correspondent to basis risk.

**Table 3: Basis Risk in Index Insurance**



In summary, index insurance fits one requirement of micro-insurance (low cost and pricing) very well while contradicting the other (securing minimum livelihood). The challenge is to find solutions or circumstances where the strength is preserved and the weakness (basis risk) is neutralised as far as possible. One proposal (Clarke and Kalani, 2012 p. 3)<sup>59</sup> consists in designing index insurance as a group policy, i.e. to cover it in a collective of insured and reduce the probability of basis risk by higher diversification and a possible setting-off of basis risk with the windfall profit which also occurs within the group. We will return to this proposal later on.

## The Sharī'ah View of Index Covers and the Solution

On first sight, the basis risk contained in the index cover can appear as *gharār* in its highest and purest form. Some of the original *fatāwās* declared conventional insurance haram, based on the pure payment-related view, i.e. that the insured pays a premium and without getting back “anything” (Sheikh Ibn Jibreen in: al-Musnad)<sup>60</sup> in case there is no loss. That could still be countered as being a somehow naïve view which does not consider the cover given throughout the period; but in the case of realisation of the basis risk, the insured gets back nothing at all *although he had suffered a loss* (case A); this is, because the cover given is imperfect. Or, in case B of basis risk, the insured gets the indemnity although he had not suffered a loss, which seems a very clear case of *ribā*.

<sup>59</sup> Also compare the original, more general idea in Clarke, 2011, p. 6

<sup>60</sup> p. 20: “because the company might take sums of money from the insured every year without doing anything for them”.

Despite this devastating perspective, there are several *fiqh* arguments against it. One is *maṣlāḥah*, public interest. The technical progress in modelling natural disasters is swift and basis risk can be reduced to a minimum, at least for certain perils and regions where the necessary data are available for modelling. Furthermore, the interest of the *ummah* in preserving the values Dr. Brugnoni had mentioned, in particular life and wealth, is prodigally realised by *microtakāful* and that can well outweigh a small residual basis risk. But this balance has to be decided by the scholars certifying a concrete *microtakāful* scheme.

The scholars who agreed to the use of index insurance under conditions<sup>61</sup> brought a quite refreshing perspective in: insurance, any kind of it, is by the majority of scholars considered as involving major *gharār* anyway and this *gharār* is forgiven by cooperative cover and the *tabarru'* construct. Since there is no further ranking within the realm of "major *gharār*" the *gharār* involved in basis risk, although it seems to be extreme compared to traditional indemnity insurance, can be forgiven just the same way.

This *fiqh* perspective is very helpful. According to the scholarly view, the major *gharār* appears only in the bilateral relation and disappears when a pool of participants gathers to carry this risk. In the technical view, just in the same way, basis risk disappears when the cover is extended to a greater community exposed to the same peril under the same parameter. If the trigger is set in any apt way, it becomes very improbable (case A) that a larger number of the participants is affected while the parameter remains untriggered. And on the other hand (case B) the more exposed risks are included in the policy, the less probable it is that nobody of them suffers a loss while the index is triggered. And even if the probability of case B is not fully removed, the *tabarru'* concept can heal it perfectly. Basis risk payments, e.g. by *retakāful* operators, can become a reserve of the community of policyholders and thus become perfectly *halal*. And they can eventually in a later period be used to help participants affected under case A. Who deserves thus a payment from the common pool of reserves can be decided by the community and its assembly, who possess all necessary information, as it works with informal security nets in nearly all Muslim societies. Finally, this equalising effect of the community cover is not an estimated and actuarially modelled effect (that can come on top when different regions are pooled). It is a direct set-off effect taking place within a limited concrete community.

It thus appears that the index technique that at first view seemed to be the most alien to Sharī'ah principles is in the end the one where the *takāful* and *tabarru'* principles as well as the *maqāsid* (the intentions behind it) flourish in the most obvious way. Always

61 This was an unpublished decision of the Sharī'ah supervisory board of Munich Re Retakaful. One of the conditions being that participants buying a cover must at least own some insurable interest in the region covered by the parameter. This requires a certain minimum evaluation effort as compared to conventional schemes. But, it happens when buying the cover, not when evaluating the loss, which would probably cause some more expenses.

provided that it is applied on a level of real, regional communities. This community based approach is in turn another established principle of microfinance theory. Because, while becoming Sharī'ah-compliant, the community approach at the same time heals the main disadvantages of index insurance when applied to the poor.

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# CHAPTER 4: RISK MANAGEMENT AND GOVERNANCE IN *TAKĀFUL*

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**Zainal Abidin Mohd Kassim, FIA**

## **Introduction**

In the short period since its inception, the definition of what exactly is a *takāful* operation has been mired in controversy. This is not to say that the *takāful* industry has not developed over the last 40 years or so since the first “*takāful*” company made its appearance; rather, what constitutes a *takāful* operation can vary significantly from country to country. Perhaps, then, rather than calling this institution “*takāful*”, a more appropriate name is “Sharī’ah-compliant insurance”. It is Sharī’ah-compliant in that it has the blessings of certain Sharī’ah scholars due to its operation being compliant with Sharī’ah principles, and it is insurance in the sense of how insurance is understood globally. As an example, we observe that in Iran the operating model endorsed by Sharī’ah scholars there looks quite similar to the Western practice of insurance. As another example, we have the Cooperative Insurance model in Saudi Arabia, where some Sharī’ah scholars have agreed that the model is Sharī’ah-compliant even though the “cooperative” nature of the operation sees only 10% of operating surplus being distributed to policyholders. At the other extreme, we have the Sudan Sharī’ah-compliant insurance model where the shareholders’ share of profits is limited to a fee for managing investments and the investment return generated by the shareholders’ funds. The Sudan Model can perhaps be best described as a cooperative model but with shareholders’ capital. The shareholders earn a fee of a percentage of the profits for the management of investments on behalf of participants, but nothing for the insurance business itself. All expenses are met by the participants.

Given the diverse range what may be considered as Sharī’ah-compliant insurance, it is very difficult to come up with a set of definitive “rules-based” risk management and governance guidelines. The alternative is, of course, principles-based guidelines. The problem with principles-based guidelines is that it requires the presence of a technically strong and informed regulator, in addition to a well-trained and experienced human capital resource pool within the industry, if it is to have a chance of succeeding. Unfortunately, the Sharī’ah-compliant insurance industry in most countries currently does not have these resources sufficiently available. This, then, exposes the industry to significant risks, which, if not managed diligently, open it to the ultimate risk, that of failure.

Given the above, this chapter focuses on the risk management and governance issues facing the *takāful* industry. It should be noted, however, that the IFSB, through its Standards and Guidance Notes, has published a comprehensive range of papers addressing the issue

of risk management and governance in *takāful*.<sup>62</sup> This chapter does not intend to churn out again the principles and standards detailed in those papers, but instead to provide a practitioner's overview as to the drivers of *takāful* and the challenges that *takāful* operators face in managing risks and structuring governance within their operations.

## The *Takāful* Concept and Risks

The author has spent 30 years as an actuary practising in *takāful* and has found that practitioners and the public still miss the point of exactly what makes insurance “*haram*”. Let us put aside the obvious fact that insurance companies invest in asset classes that are *haram*.

Is insurance *haram* because the insured pays a small premium and is rewarded with a big payout should the insured event occurs? The point missed by many is that the basic purpose of insurance is to function as a risk-mitigating tool. The sum assured paid must only be enough to compensate the insured for the loss he or she incurs as a result of the contingent event occurring. Thus, if a car is worth \$10,000 in the market at the time it was stolen, the insurance company would only pay \$10,000 regardless of whether the car was insured for \$20,000. The insured is not gambling by taking up insurance, as he does not gain financially from the event occurring. In the example, the \$10,000 the person receives from the insurance company would go towards buying a similar car (used/second-hand car) to put him in the same financial position that he was in before the car was stolen. The definition of gambling is to profit or to incur a loss as a result of an outcome that is beyond the control of the gambler. Think slot machines or the roulette table. If the gambler wins his bet, his net worth increases by the amount of his winnings. In the case of the insured whose car was stolen, his net worth is not increased by the event as the insurer only financially compensates him up to the amount of his loss.

What makes proprietary (shareholders' capitalised) insurance *haram* is that the insurance company's profits are driven by whether the premiums it collects are more or less than the claims it pays. The company is taking speculative risk (see Box 4.1), not unlike in a “gamble”. In some years, it makes an underwriting profit; in other years, it makes underwriting losses. Of course, the insurer takes on many risk-mitigation steps to ensure it has sufficient capital to weather losses, and it uses diversification and reinsurance extensively to reduce the volatility arising out of its underwriting experience and to minimise the possibility of making a loss. This “gamble” occurs as the insurer takes on the risk faced by the insured in exchange

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62 The papers include IFSB-8 (December 2009): *Guiding Principles on Governance for Takāful Undertakings*; IFSB-9 (December 2009): *Guiding Principles on the Conduct of Business for Institutions offering Islamic Financial Services*; IFSB-10 (December 2009): *Guiding Principles on Shari'ah Governance Systems for Institutions offering Islamic Financial Services*; and IFSB-14 (December 2013): *Standard on Risk Management for Takāful Undertakings*.



for a premium consideration. There is, in effect, a risk transfer between the insured and the insurer for the consideration of the payment of a premium.

In Sharī'ah-compliant insurance, there should instead be risk sharing between the policyholders (called "participants", as they "participate" in the risk-sharing process, rather than "hold" a policy sold by the insured). The insured, in effect, is also the insurer and the intention of the participants is not to profit from underwriting surplus but to assist their fellow participants to meet obligations that have arisen due to the happening of the insured event. The premiums are pooled from all the participants and any claims are paid out from this pool of contributions.

## Major Risks in Sharī'ah-Compliant Insurance

By defining the major risks, we can then determine the boundaries of Sharī'ah-compliant insurance. Different types of risks that Sharī'ah-compliant insurance faces are discussed below.

**Risk 1:** If there is significant volatility in the claims experience and participants expect all claims arising to be paid (i.e. guaranteed), then, given that there is no "capital" involved, it is only a matter of time before the operation would fail.

### Box 4.1: Speculative Risk

Does knowing for "certain" the probability of an event make it less of a gamble? If you were to toss a coin 1,000 times, the probability of "heads" or "tails" will be 50%. In insurance, the law of large numbers is the basis of risk taking. Insurers do not take on risks that they cannot quantify. Part of that quantification process is estimating the probability of a claim. The greater the amount of claims data available, the greater the precision of this estimate. The insurer usually, however, has no "power" to determine whether the insured event will occur or otherwise. The process of underwriting selects the types of risks the insurer undertakes, but the insurer still cannot influence subsequent events. The speculative aspect of the risk applies, as the insurer's profit or loss is determined by whether the claims experience is better or worse than expected. If the experience is exactly as expected, then the insurer in theory makes neither a profit nor a loss. A cursory glance at the profit and loss statements of insurers will show that, for general (i.e. casualty business) insurance, a big component of profit or loss is from the underwriting aspect of the business. Indeed, the capital and solvency structures for insurers are based on the premise of: the greater the risk taken, the higher the required capital and solvency margin. This correlation would mean that profit margins tend to be bigger, the higher the risks underwritten, just to service this capital.

Non-insurance-related business takes on only business risks; the success or otherwise of the business depends on the business strategy and effort of the entrepreneur. The entrepreneur is able to influence the future outcome of his business through how he manages the business. For the insurer, once he underwrites and accepts the premium the die is cast and he has no influence on its outcome.

Thus, one risk is not being able to pay all claims arising. Put another way, can the participants expect that all claims could be paid from the premiums collected? To ensure this, regulators would require evidence that the *takāful* operator is sufficiently capitalised before allowing *takāful* to be set up in their jurisdiction, and thus the hybrid operating model was born. In the hybrid model, we have the structure shown in Figure 4.1:

**Figure 4.1: Hybrid Nature of *Takāful***



The role of capital in this hybrid is to facilitate the ability of the participants' risk pool to pay the insured amounts as claims occur through an extension of an interest-free loan to the participants' pool. The *takāful* shareholders are, in effect, the "private banker" to the participants' pool when required. However, this loan facility, even though it is interest free, does not come "free". There is a cost involved, which the participants have to pay, and the business model adopted by the shareholders to manage the *takāful* operation will give rise to specific governance and risk management issues.

**Risk 2:** The hybrid nature of Shari'ah-compliant insurance introduces another stakeholder whose interests are not necessarily aligned with those of the participants. The business model itself can carry significant and varied governance and management risks because of this misalignment.

Is it possible to have a Shari'ah-compliant insurance operation without the introduction of capital providers who are not also themselves participants? Indeed, yes – but this would require two important conditions to be met:

- (i) The sum covered (insured) is not guaranteed. Effectively, on a claim, the risk pool will meet the claims on a "best effort" basis.
- (ii) Appropriate regulations are in place to regulate these "capital-less" entities.

Such operations are called discretionary mutuals, and exist in the UK and Australia and apply only to affinity groups.

It would be pertinent to note that such arrangements would normally be limited to risks where the frequency and severity of claims arising are predictable to ensure that in most cases claims arising would be paid in full. This, then, brings us to the third major risk faced by Sharī'ah-compliant insurance operations.

**Risk 3:** The Sharī'ah-compliant insurance operation should only pool risks for which it has the capital resources to manage volatility and other operational risks. It would be appropriate not to guarantee that all claims would be paid in full if sufficient capital is not available to manage claims volatility.

It is important, therefore, to note at the outset that managing risks in *takāful* starts from the beginning, even before one opens up for business. It has to do with how one structure the operating model, what are the intentions of the shareholders in investing in *takāful*, what are the expectations of participants, and what insurance risks you plan to underwrite. These are discussed next.

## ***Takāful* Operating Models**

### ***Saudi Cooperative Model***

Many Sharī'ah scholars have expressed reservations as to whether the Saudi cooperative model is truly Sharī'ah-compliant. Sharī'ah scholars, of course, are known to have differences of opinion in many instances, especially when it involves issues where the Prophet Muhammad (peace be upon him), has not given explicit guidance. Instead of focusing on the Sharī'ah issues of the model, the reasons given by a Saudi practitioner as to why this model was adopted in Saudi Arabia are presented. His rationale for this cooperative model was:

- (i) It promotes price competition between insurers. Effectively, insurers are free to set the price for their insurance products. They can price at a loss, for example, to gain market share and effectively use their capital to subsidise the premiums until such time as they can increase their premiums to turn a profit. They are incentivised to do this, as 90% of profits accrue to shareholders. All losses would be for the account of the shareholders, so there is no such thing as a loan from the shareholders that has to be repaid from future profits. From the regulator's perspective, their primary concern would be solvency. Insurers are free to set their rates as long as they are solvent and are expected to remain solvent over the long term. Well-capitalised insurers tend to have the upper hand in such a market.

- (ii) Full accountability is on the shareholders, as their policyholders have effectively transferred their risk of loss to the shareholders. Shareholders are financially accountable for the business decisions made by management. The governance structure has the management reporting to the board of directors, which is usually dominated by representatives of the shareholders rather than independent directors. The standard risk management practice that applies to well-run insurance companies applies to the cooperative insurance model as well.
- (iii) Unlike *takāful*, the cooperative insurance model does not restrict access to the conventional reinsurance market. This would mean that insurers in Saudi have access to the USD 565 billion<sup>63</sup> total capital available in the global reinsurance market and, with it, the capacity to write huge risks.

Such a model also provides other operating advantages, not least that there is already a large pool of talent from the global insurance market from which to fill positions within the company and readymade systems to implement which are competitively priced and well tested. A regulatory template<sup>64</sup> for such an operating model is also readily available.

The non-traditional risks, however, posed by this model can be summarised as follows:

- (i) Sharī'ah risk. For those who purchased the insurance policy with the understanding that it is Sharī'ah-compliant, there is a risk that this compliance may be challenged in the future. This risk is also applicable to those investors who invested in the insurer on the understanding that it is Sharī'ah-compliant. It is our understanding, however, that insurance policies in Saudi are generally not sold on the basis of Sharī'ah compliance. There is the huge expatriate working population in Saudi for which Sharī'ah compliance may not be the overriding issue.
- (ii) Although the policyholders' share of the surplus arising from the business is small at 10%, how this surplus arises and is distributed poses not an insignificant governance issue. A pertinent question that has to be addressed is policyholders' expectations of their surplus at the point of sale. This issue will be of greater concern when we consider later the participants' expectations under the hybrid *takāful* operating model. Our understanding is that the surplus distribution aspect of the cooperative model is not a significant selling point in Saudi. Thus, from the perspective of policyholders' reasonable expectations (PRE), there is no obligation to ensure that the surplus is determined and distributed on an equitable basis. This aspect of governance is a thorny issue with respect to with-profits life

63 Aon Benfield (2016), *Reinsurance Market Outlook*, January.

64 Guidance provided by the International Association of Insurance Supervisors through its Insurance Core Principles, Standards, Guidance and Assessment Methodology.

policies, which are modelled after the UK participating policies with discretionary bonus distribution. It is pertinent to note that, in general insurance, it is unusual to distribute surplus to policyholders. This is partly due to the risk transfer nature of general insurance, and the fact that when the same risks are underwritten at different “prices”, such distribution of surplus on a “fair” basis is nearly always impossible.

### ***Takāful Muḍārabah Model***

It is pertinent to appreciate the role of “contract types” in moulding the *takāful* industry. These contract types were in existence even before the time of Prophet Muhammad (peace be upon him). The contract type provides a basis with which to establish *takāful*, as Sharī’ah scholars are familiar with how these contracts work. It is also important to appreciate that there are no reasons why new contract types could not be constructed; however, given the difficulty envisaged to get Sharī’ah scholars’ consensus on new contract types, the Islamic finance industry, which includes *takāful*, finds it expedient to arrange business transactions around the existing contract types, which have been around for centuries.

So, what exactly are contract types? In modern legal contracts, the terms of the agreement are spelled out in detail in the contract and can basically include anything. To be enforceable in the courts however, the contract must not include criminal activities. The basis of contract types is to define a contract by its “type”. This has the advantage of emphasising the general agreement between the parties to the contract, leaving only the details of the contract to be set down on paper. The *muḍārabah* contract is one such contract type. It is basically a partnership contract between one party, who is the capital provider or investor, and the second party, who is the entrepreneur.

Under this contract type, the general understanding between the investor and the entrepreneur can be summarised as follows:

- (i) The investor does not involve himself in the day-to-day running of the business. Ownership of the assets/business funded by his investment, however, remains with him at all times.
- (ii) The entrepreneur is not allowed to draw from the amount invested any remuneration for his efforts.
- (iii) The investor and the entrepreneur agree at the outset how any profits from this venture are to be distributed between them. This is usually set as a percentage of any profits arising during the period of the agreement.

From a corporate governance perspective, the investor has no “representation on the board”, so to say. Apart from the initial understanding as to what the business is and what is its objective, the way in which the business is run is left entirely to the entrepreneur. The investor’s “control” of the entrepreneur is that if the business is unsuccessful the entrepreneur is not able to recoup the expenses he has incurred in the business. This means that there is an alignment of financial interest between the investor and the entrepreneur. All financial losses arising from the business, however, are solely on the account of the investor, while any profits are divided between the investor and the entrepreneur on a pre-agreed basis. From the entrepreneur’s perspective, the net bottom line would only be a positive should the profit reaped from the business exceed the expenses expended for the venture. The risk for the investor, on the other hand, is that the venture makes a loss.

In 1983/4, a task force was established in Malaysia to determine how best to start *takāful*. In the end, the task force settled on the *muḍārabah* contract type with which to establish *takāful* in Malaysia. The idea was that the shareholders would be the entrepreneur and the *takāful* participants the “investors”. There would be separate and segregated funds established for the shareholders’ capital and participants’ pool. All expenses (other than those deemed expenses that can be attributed to individual participants) would be charged to the shareholders’ accounts. Profits would be determined on a yearly basis and shared at an agreed percentage between the shareholders and the participants. The shareholders’ fund would provide an interest-free loan should the participants’ pool incur a deficit.

This operating model was frowned upon by some Sharī’ah scholars, in particular those based in the Middle East. The general argument against this model was that the contribution (i.e. premium) was used to pay claims and thus, as the “capital” (i.e. contribution) was depleted by this payment, no profit actually arises. In actuarial terms, we called this excess of premiums over claims “surplus”, not “profit”.

As expected, it took a long time for the first *takāful* company in Malaysia to turn a profit (defined as when the shareholders’ share of underwriting surplus exceeds management expenses) for its shareholders. There was always the risk that this business model would fail should the participants’ pool continue to show losses, and should the *takāful* operator’s share of surplus fail to meet the substantial expenses being incurred by the shareholders’ fund.

The operating business model for *takāful* operators in Malaysia has now moved on from the *muḍārabah* model. This has to do with price competition, which came about as more and more *takāful* operators entered the market and contribution rates dropped to “market levels”. It then became more difficult for the participants’ pool to generate a surplus and, because of competition; any surplus was too small to meet shareholders’ expenses. Thus,

any *takāful* company set up on the *muḍārabah* model carries a significant risk of failure, as the business model itself is unsustainable in light of the way in which the insurance/*takāful* market operates.

The close alignment under this operating model between the financial interest of the shareholders and that of the participants, however, is to be commended, as the management has to ensure that the participants' pool continuously generates a surplus of which their share is an amount that can meet the expenses of running the business.

Apart from in Malaysia, Indonesia, Brunei and Sri Lanka, the author is not aware of *takāful* operators that have used the model described above as their primary operating model. Even in Malaysia, and for new business, no *takāful* operator is currently using this model as its primary operating model. As a final note on this model, in Egypt, the definition of *muḍārabah* operating model is slightly different in that all management expenses, including distribution costs, are instead charged to the participants' pool. Only expenses unrelated to running the business (e.g. cost of investing the shareholders' capital) are charged to the shareholders' account. Here, therefore, is one clear example of the different ways in which Sharī'ah scholars in different countries interpret the implementation of the same named contract types, adding to the difficulty in determining a standard rules-based enterprise risk management (ERM) programme by contract type.

Under the Egyptian interpretation of the *muḍārabah* contract, the close financial alignment between the shareholders and the participants is less tight. Any interest-free loan payable to the participants' pool under the interpretation of *muḍārabah* is therefore also used to cover expense overruns, in addition to when claims exceed premiums. Expense overruns occur when the expenses incurred are in excess of the expense loading priced into the contribution rates. This occurs for all new start-ups as they build their business volume to be commensurate with their expense base. This interpretation of the *muḍārabah* model is less favourable to participants as compared to that adopted in Malaysia.

### ***Takāful Wakālah Model***

Another contract type that is used by *takāful* operators is the *wakālah* model. "*Wakālah*" means "agency", and so under this contract the *takāful* operator is the agent of the participants, which is entrusted to manage the *takāful* business on behalf of the participants. For this service, the *takāful* operator receives a fee, normally expressed as a percentage of the contribution. The Arabic word "*wakālah*", from the author's understanding, also binds the agent as a trustee of the participants. This interpretation is important, as the role of trustee would require that the agent conducts the business in the best interests of the participants. This part of the responsibility of a *wakīl* (agent) is usually lost on the part of management and the board of directors, whose allegiance would seem to be to the shareholders first and

the policyholders only second. Thus, the major issue with this *takāful* operation model is that of governance.

The income to the operator being a percentage of contributions would imply that the financial interest of shareholders is best served by maximising turnover and minimising expenses, rather than by ensuring that the participants receive the best service and the participants' pool is financially sound. Indeed, this misalignment of interest is the greatest risk posed by the *wakālah* model. Under this model, the regulator has to act as the "referee", so to say, to ensure that both shareholders and participants are fairly treated. There have been calls for participants to be represented on the board so as to safeguard the interest of participants. Another suggestion to address this misalignment is to establish a separate "board" that will represent the participants' interest in the *takāful* operation. This participants' board would be filled by professionals who can advise on whether the operator is acting in the best interest of the participants.

The problem with a separate advocacy body is that of dispute resolution. How would disagreements between the participants' board and management be resolved in a timely manner? Perhaps a more workable solution is to fall back on the trusteeship role of the *takāful* operator. Under trust law, trustees are personally responsible for their decisions.<sup>65</sup> Regulators can provide guidelines as to the responsibility of the members of the board and have the power to impose sanctions should any member of the board fail in their responsibility towards the participants. At a minimum, the majority of the board of directors of the *takāful* operator should consist of independent (independent of shareholders) directors.

It would be opportune to address pricing risk when discussing the *wakālah model*. Pricing risk applies to all insurance operating models, *takāful* or otherwise, as it covers the risk that the premiums charged are not adequate. If the pricing is not appropriate for the risk, then it would only be a matter of time before the operator would be called to provide a loan to the participants' pool. Pricing is also dependent on the type and level of underwriting that is undertaken.

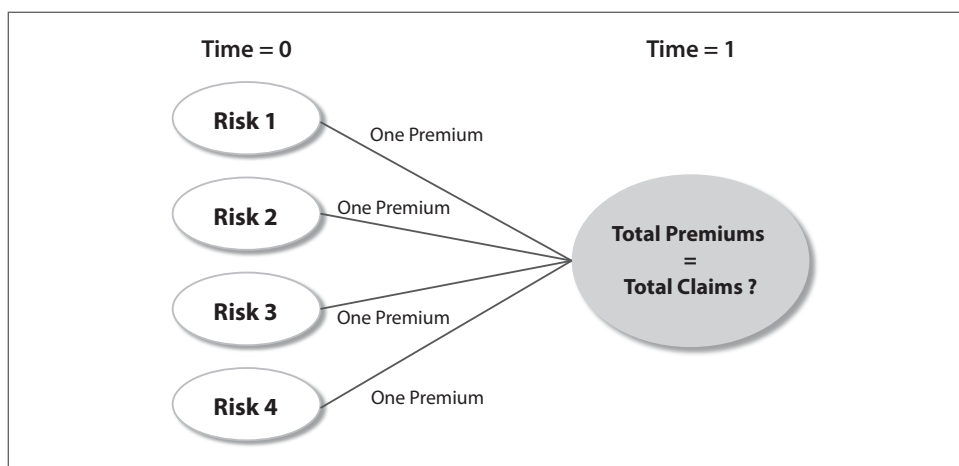
## Underwriting: Types and Implications

There are basically two ways of underwriting: community-based underwriting (see Figure 4.2) and risk factor-based underwriting (see Figure 4.3). Under community-based underwriting, one premium rate is applied regardless of the level of risk assumed.

<sup>65</sup> In an agency contract the agent acts as the representative of the owner of a usufruct. The agent's role is to promote his client or his client's property. Under the *wakālah* contract, this agency role extends to putting the client's interest above the agent's own self-interest, similar to the role of trustees over the assets held under trusteeship.

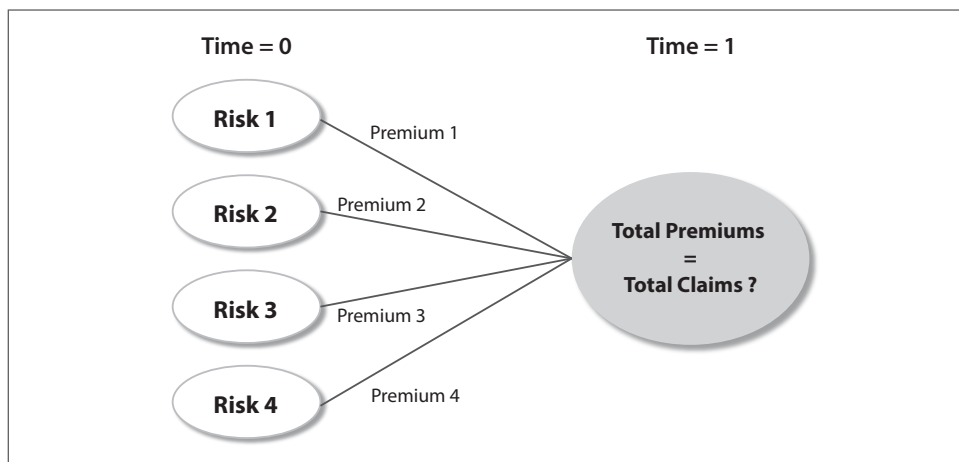


**Figure 4.2: Implications of Community-based Underwriting**



Under risk factor-based underwriting, the premium rate applied to the sum assured is driven by the level of risk assured as determined by specific risk factors.

**Figure 4.3: Risk Factor-based Underwriting**



In the early days of *takāful*, an idea was floated that contributions to the risk pool (called *tabarru'*, or donation) should be determined on community-based underwriting (see Box 4.2). This perhaps has to do with the extrapolation of risk sharing to the highest level, that contribution to the risk pool is a good deed and, as such, should not be discriminatory based on how likely the participant is to make a claim. (For example, with community-based underwriting and in medical insurance, the sick would contribute the same as the healthy.) There are three fundamental reasons why community rating would not work in ensuring that sufficient funds are accumulated to pay claims in a pool:

- (i) Community underwriting presents a greater chance of mismatch between total premiums collected at time=0 and total claims incurred at time=1, as risks pay premiums which do not reflect the chances of claims arising.
- (ii) Community underwriting is common for social security programmes that are either partly or fully funded by the government. For example, in Australia, the government pays 30% of the medical insurance premium (on a means-tested basis) and health funds are prevented from discriminating against members on the basis of health status, age or claims history, the usual risk factors used to determine the level of premium payable in private medical insurance.
- (iii) The third reason is the commercial aspect of *takāful*, where *takāful* operators vie for contributors to their pool and participants would choose the “cheaper” pool to which to contribute.

#### **Box 4.2: *Tabarru'* and the *Waqf* Model**

Contributions to the risk pool are structured as a unilateral contract – in this case, as a *tabarru'* or donation. Sharī'ah scholars have opted to denote it as such to “legalise” the uncertain nature of such payments into the risk pool. Insurance premiums are not considered Sharī'ah-compliant bilateral contracts, as the terms of the payments are not considered “transparent” or “certain”, for the following reasons:

- (i) As the premium is determined on the basis of “take it or leave it” to the insured, it is deemed to be an unfair bilateral contract.
- (ii) The duration of the premium payment is dependent on whether the payer survives the duration of the contract.
- (iii) There may or may not be a payment to the policyholder, and the quantum of such payments may not be known at the outset of the contract.

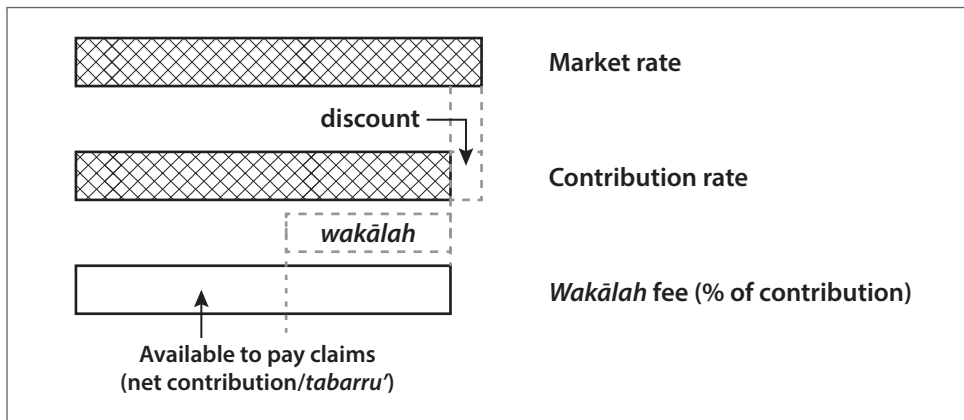
By treating risk premiums as *tabarru'*, the three Sharī'ah concerns are side-stepped as, instead of a bilateral contract, the payment is now a unilateral contract – a donation. Under a unilateral contract, there is no need to dictate terms under which such donations are made.

This approach has some Sharī'ah scholars questioning the nature of the fund into which the *tabarru'* is paid. Under what circumstances are claims paid? How are the participants tied to making regular *tabarru'*? To address these concerns, and in some *takāful* companies, the risk pool is labelled as a *waqf* (a trust fund). The *waqf* is instituted by the shareholders by making a small *waqf* contribution (which cannot be repaid to the shareholders) to the pool, effectively to establish the *waqf*. The *waqf* would be instituted with certain rules and conditions as to what contributions participants should make to the pool (these contributions are still deemed as *tabarru'*) and what payments can be made out of the *waqf* pool.

In addition to determining how much to charge for each risk, there is also a need to cover the management expenses incurred by the *takāful* operator. Together this would then constitute the contribution to be paid by the participant to the *takāful* operator. However, in many instances, the contribution rate is determined by market rates instead of by an analysis of the two major constituents of the contribution rates – provisions for claims and for expenses.

Under the *wakālah* model, the operator would determine what *wakālah* fee is payable. This rate could be explicit for each contract, or it could be set for all contracts at the beginning of the year for contracts in force in that year. The question, then, is how to determine this *wakālah* fee. Participants usually have no say on how it is determined. Their only sanction, should they disagree with the fee, is to cancel or not renew their contract. This cancellation does not usually happen, as the participants normally only react to the “gross” contribution (i.e. total premium), not the *wakālah* fee payable itself. How, then, is the gross contribution determined? Unfortunately, in many instances, the gross contribution is determined by taking the “market” rate and providing a “discount”. Figure 4.4 illustrates the process.

**Figure 4.4: Shortfall in *Tabarru'* Contribution**



Thus, when setting the *wakālah* fee, the *takāful* operator sometimes overlooks the possibility that the net contribution rate (i.e. the contribution rates less the *wakālah* fee) would be inadequate to meet claims. There are three instances here where mispricing risk can occur:

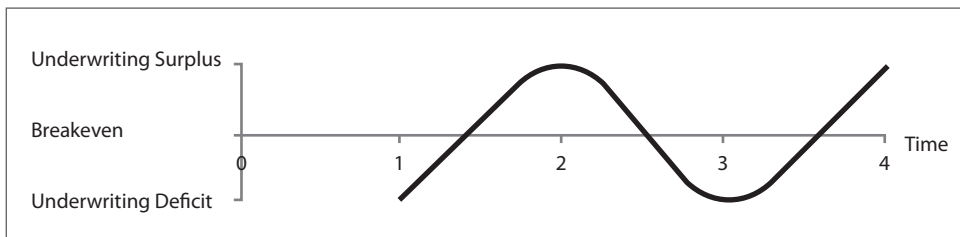
- (i) When the contribution rate is set by reference to the market rate without due consideration of the underwriting process adopted by the *takāful* operator, the operator's own expected claims experience and the operator's own expense base.
- (ii) When an indiscriminate discount is provided on the market rate (presumably to facilitate the “selling” of the *takāful* product but sometimes on compassionate grounds) which is likely to make the rate technically insufficient. These discounts have been known to vary from participant to participant, raising the issue of equity between participants.
- (iii) When, after deducting the *wakālah* fee, insufficient *tabarru'* funds are available to meet claims, as no check is made of this beforehand. It is easy for management to make this error when claims are assumed to be the participants' responsibility, as underwriting losses can be carried forward indefinitely.

The operator, when setting the *wakālah* fee, has in mind its own expense base, as that can be determined with some accuracy. Thus, if its expected contribution turnover for the year is 1,000 and the budgeted expenses are 600, the *wakālah* fee would be set at 60%. The problem with this simple computation is that:

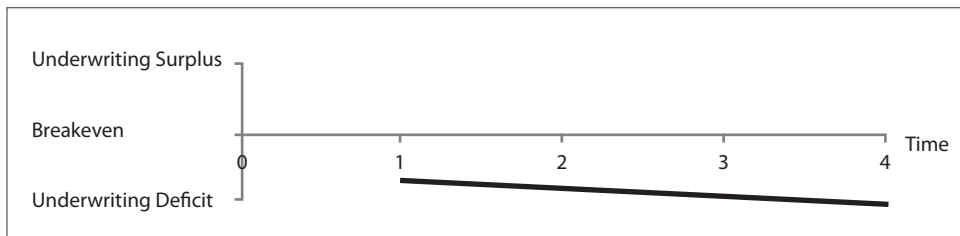
- (i) The 1,000 is determined based on market rate; that is, it is based on some other operator's expense and claims experience, with probably even a further discount on the rate.
- (ii) The amount of the contribution net of this 60% *wakālah* fee determined on this basis is not likely to be able to meet claims payable, as the market rate was probably based on the expense ratio of a well-established insurer or *takāful* operator, rather than a *takāful* start-up. For a well-established insurer or *takāful* operator, its expense ratio would be a smaller percentage of the premium charged.

This mispricing would result in a deficit in the participants' pool which would need to be funded by a loan from the operator. It is arguable that such transfers to the participants' pool should not be considered as loans but as outright transfers, as the operator has mispriced its products. The intention of loans to the participant pool is not to cover underwriting losses, but to smooth out claims volatility. Figures 4.5 and 4.6 illustrate the fundamental difference between the two types of deficits in the participants' pool.

**Figure 4.5: Effect of Claims Volatility on Underwriting Results**



**Figure 4.6: Effect of Mispricing on Underwriting Results**



From a governance perspective, it is important to distinguish between the two types of deficits as treating recurring underwriting deficits as claims volatility when it is actually the result of mispricing can result in fundamental errors in management's decision-making process. This is especially so if the shareholders' revenue account shows that the operator is making a profit (as *wakālah* fee exceeds management expenses) and management chooses to treat the continuous injection of loans to fund the participants' pool's deficit as "temporary" and "recoverable".

### ***Underwriting Risks and Governance***

The above analysis raises the question of how this governance issue can be resolved under the *wakālah* model. The most obvious route would be to place conditions on how *wakālah* fees are set. Until quite recently, there were no regulations on the setting of *wakālah* fees. Recent changes in the regulations in Bahrain, for example, now require that the actuary certifies that the net contribution that goes into the participants' pool is expected to be sufficient to meet claims. This requirement therefore requires a continuous review of the adequacy of this net contribution rate. To be prudent, regulators would also disallow the admissibility of the operator's accumulated loans to the participants' pool for the purpose of capital in determining the solvency position of the *takāful* operator.

### **Intentions of Shareholders**

The ultimate stakeholders in modern *takāful* are not the participants (unfortunately), but the shareholders. Shareholders provide the capital with which to start the business. Shareholders fund the expense overruns that the *takāful* operation is sure to incur in the initial years when expenses are naturally expected to exceed that which can be supported by contributions collected. Shareholders also are required to ensure that the solvency requirement is satisfactorily met by the *takāful* operator at all times. It is therefore important that shareholder/investors understand exactly what they can expect when investing in *takāful*. As *takāful* is still in its infancy, the industry cannot afford to have *takāful* shareholders walking away from their investment, as this would deter new investments in *takāful*. Unlike proprietary insurance, where the risks are generally understood by investors, the *takāful* experience shows investors are attracted by the "strong growth" demonstrated by the industry and are erroneously interpreting that feature as "big profits". *Takāful* set-ups are without exception start-ups, and start-up risks are sometimes overlooked by investors in *takāful*. These start-up risks are in addition to issues such as model risk (which *takāful* operating model to adopt), systems risk (which computer system to purchase/build), Sharī'ah risks (who to recruit as Sharī'ah advisors, and whether these scholars will be supportive of the business), management risks (how to recruit the right team) and regulation risks (whether the regulator will issue an operating licence, and whether the regulations are supportive of *takāful*).

The regulator, being the gatekeeper to new entrants to the *takāful* market, plays a crucial role in vetting new investors in *takāful*. In addition to sufficiency of capital (not just start-up capital, but enough capital at the outset to fund the operation over the years until it is expected to be profitable on a sustainable basis), it must be convinced that the investors understand the risks of venturing into *takāful* and have an experienced management team with which to execute the business plan. The importance of an experienced management team cannot be over-emphasised, as we see in many markets a high turnover of top management when boards of directors become impatient with the financial results of the company being consistently in the red. While many of the troubles faced by *takāful* operators can be attributed to faulty business plans put in place by management, part of the blame can perhaps be attributed to the regulator not being sufficiently rigorous when vetting new investors in *takāful* and not accurately gauging the ability of the market to support so many *takāful* operators.

*Takāful* operations in some markets suffer from excessive competition not just from insurers, but also from other *takāful* operators. Malaysia's experience in *takāful* was one of progressive development of the *takāful* industry. For example, Syarikat Takaful Malaysia was the only *takāful* operator given a licence to operate in the Malaysian market for nearly 10 years. Over that period, the human capital for *takāful* was developed and *takāful* was able to effectively build a business base through its unique offering. It competed in the market based not on price, but instead on its Shari'ah-compliant offering. This allowed it to price its products appropriately without having to compete with insurers and, more importantly, other *takāful* operators. Its surplus-sharing model allowed it to adjust the initial premium rate charged when claims experience is favourable. This is a fairer basis of distributing the benefits of *takāful* to participants and the shareholders.

What are the ideal attributes of investors in *takāful*? For certain, *takāful* is not a suitable investment for investors who are looking to make a quick profit. Certainly, *takāful* can be profitable to investors over the long term. In Malaysia, Syarikat Takaful Malaysia and Etiqa Takaful are two examples of *takāful* operations that have grown from strength to strength. Their success is due also to a government that actively supports the Islamic finance industry, and to a regulatory environment that, for the most part, is supportive of the industry.

An ideal investor in *takāful* would be one that supports the "spirit of *takāful*" first and profits second. It is important for investors to appreciate at the beginning that it is unlikely that an investment in *takāful* will be more profitable than one in insurance. One is risk sharing (sharing profits with participants), while the other is risk transfer (keeping all the profits with the investors). It is not impossible for *takāful* investors to reap higher profits in *takāful* than in insurance, but this can only happen if market conditions favour the risk-sharing model over the risk-transfer model. An example of market conditions that favour *takāful* is the fire

tariff applicable in Malaysia. As the tariff applies to *takāful* operators and insurers, *takāful* operators are shielded from the negative effect of excessive competition based on premium rates and participants benefit from a sharing of the underwriting surplus.

It would not be inappropriate to assume that an investor chasing a return higher than one the investment can offer would take on board more risks in its business plans. In an insurance market, the maxim “survival of the fittest” can accommodate such risk taking, but the *takāful* market is different and that treating *takāful* the same as insurance when putting in place regulations would be a disfavour to the industry if the intention of the government of the country is to grow this market to a level that can provide a viable and Sharī’ah-compliant alternative to the conventional insurance industry.

## Intentions of *Takāful* Participants

To some observers of *takāful*, one reason why Islamic insurance has failed to be as successful as expected is the “lack of support” from the Muslim population. The complaint is that a Muslim’s choice of insurance is not driven by whether it is *halal* (i.e. permissible) or *haram* (i.e. forbidden), but solely by price. Perhaps from the Muslim public’s point of view the value proposition of *takāful* is not strong enough to justify paying a premium (over the cost of a similar insurance contract) for *takāful*? Muslims would gladly pay a premium for slaughtered meat, as it has been medically proven that slaughtered meat is healthier for consumption than non-slaughtered meat. Perhaps they do not see any difference between the *takāful* offering and the insurance offering to justify paying a premium for *takāful* over insurance. Unfortunately, it is generally true that *takāful* would be priced higher than insurance for the same risk. The reasons for this include:

- (i) *Takāful* operations are nearly always start-ups, and start-ups – whether *takāful* or insurance – initially have higher expenses per unit of risk underwritten.
- (ii) *Takāful* has an additional layer of governance (the Sharī’ah board) which costs have to be added to the premium.
- (iii) *Takāful* is a surplus-sharing model. Participants expect a surplus to arise and to have a share of that surplus. Most of the time, such expectations can only be realised if the contributions are priced higher than insurance premiums, as in insurance the shareholders do not share surplus with policyholders.
- (iv) Higher cost of *retakāful*. It is sometimes overlooked that *retakāful* costs are generally higher than reinsurance for the same risk. Several *retakāful* operators have exited the *retakāful* business, as it would seem their own business model is not sustainable.
- (v) Regulators generally have applied the same capital requirements to *takāful* as for insurance, notwithstanding that the former is a risk-sharing model. To be fair to

regulators, however, *takāful* operators have not proven to the regulators why their risk-sharing model deserves capital credit when determining solvency capital.

The above observations would seem to point to several worrying trends and risks for the *takāful* industry:

- (i) To succeed, from a turnover perspective, requires the *takāful* operator to compete on price, then the business model is financially unsustainable.
- (ii) If *takāful* is sold on the basis of surplus sharing and no surplus ultimately arises as a result of inadequate pricing, the consumer will be severely disappointed and the reputation of the *takāful* industry will be undermined.
- (iii) It is observed that there are limited differences in consumer experience/outcomes in *takāful* as compared to insurance. There are no initiatives that the author is aware of to differentiate *takāful* from insurance from the consumer perspective, other than the expectation of a contribution refund when a surplus arises. *Takāful* is often sold as “Sharī’ah-compliant insurance” – that is, insurance that has the blessing of Sharī’ah, rather than as a different product from insurance. As from a service and reputation perspective, *takāful* is sometimes seen as providing service that is inferior to that provided by the household insurance “names”, the absence of differentiation in product offering would sooner or later result in a deterioration of consumer support.
- (iv) In Malaysia, a large proportion of *takāful* participants are non-Muslims. This has to do partly with the nature of the distribution network unique to some intermediaries and partly with the ability of many *takāful* operators to generate an underwriting surplus due to the tariff applicable to the motor and fire classes (see Box 4.3). A participant would therefore benefit from a *takāful* contract in such a tariff environment as, net of surplus refund; *takāful* is “cheaper” than a similar insurance product. This tariff is expected to be lifted soon and, should *takāful* operators no longer be able to generate underwriting surplus in a detariffed market, it is a matter of time before the non-Muslim support of *takāful* dissipates.
- (v) The level of financial awareness among Muslims is nowhere near as high as that of other groups. This has partly to do with the generally lower income level of Muslims in many Muslim-majority countries. Among the lower income group, insurance has as yet to make a significant contribution, as this segment of the market has a lower premium size and consequently is expected to result in lower profitability to insurers. The author has not seen any sustained effort by *takāful* operators to service this segment of the market. However, we believe that *takāful* operators ignore this market to their peril, as it is probably one of the few segments of the insurance market where risk sharing has an advantage over the risk-transfer model.



**Box 4.3: Tariff**

In Malaysia, motor (vehicle) insurance and fire insurance are currently governed by an industry-mandated premium tariff structure. These tariffs apply to insurance and *takāful* operators. This premium tariff is based on certain mandated risk factors where the premiums insurers charge are subject to a minimum tariff (which, due to competition, becomes the maximum premium charged). Certain motor and fire tariffs are profitable. For those profitable tariffs, a *takāful* contract offers an advantage over a similar insurance contract as for *takāful* the participant (i.e. the policyholder) gets to share in the underwriting surplus that arises. This potential premium “refund” makes *takāful* more attractive than a similar insurance policy.

How, then, can we overcome what seems to be the inevitable relegation of *takāful* to a boutique offering rather than a worthy replacement for insurance? No amount of regulatory tinkering on managing risk or structuring governance will be effective if the consumer is not satisfied with the product. This risk should be addressed on an industry basis. The question, then, is: is the industry even aware of the approaching tsunami? A rejection of *takāful* by the public, as it sees no difference between *takāful* and insurance, forms the consumers’ outcome perspective.

Before leaving the topic of participants’ intention/expectations, it is necessary to address the issue of surplus distribution. Surplus sharing is the only obvious difference between *takāful* and insurance and thus should be considered carefully by the *takāful* operator and the regulator. There are two aspects of surplus distribution: surplus distribution between participants, and surplus distribution between participants and the operator. Surplus distribution between participants is a powerful marketing tool. The traditional insurance model has, in many markets, fostered public suspicion of insurers, particularly so as the insurers keep on raising premium rates while seeming “always” to be making profits. Surplus sharing is a means of achieving the following:

- (i) *Adjustment of the initial cost of cover to reflect actual claims experience.* This is to be expected in a risk-sharing model. Surplus sharing does not mean distributing profits to the participants; participants are not making a profit from *takāful*, as the surplus refund is always lower than their contribution.
- (ii) *Enhanced transparency in the pricing mechanism.* How many insurance companies would effectively share their resultant loss ratios by class of risks with the insured?

In *takāful* it must be recognised that any surplus arising from the participants’ pool is a “communal” surplus, not a surplus belonging to any particular individual or any particular group of individuals. This communal nature of the surplus is a necessary feature of *takāful*, as the first charge on surplus arising in any year is to repay past loans from the shareholders to the participants’ pool. It is very difficult to identify sources of surplus unless this has been

specifically “priced” into the product. Pricing and surplus distribution are therefore invariably interlinked in *takāful*. The definition of surplus itself should consider the sustainability of the participants’ pool and the grouping of risks. This grouping, in turn, would define the community to which any surplus arising belongs. Thus the pricing of the *takāful* product and the determination of surplus that can be distributed should be thought through with great care. Furthermore, in order to ensure that the participants’ expectations are managed, the operator should clearly define its surplus calculation/sharing basis as part of its governance process.

Surplus sharing with the operator is a contentious issue. While all Sharī’ah scholars would seem to agree that any underwriting losses must be for the account of the participants, many Sharī’ah scholars are of the view that the operator is not entitled to share in any surplus arising. According to this school of thought, surplus sharing by the operator is inconsistent with the *wakālah* contract type and an undesirable “carry forward” from the conventional insurance model where the shareholders profit from underwriting surplus at the expense of the policyholders.

Malaysia practises the surplus-sharing model with the *takāful* operator. However, a limit is placed on the proportion of surplus to which the operator is entitled. This surplus-sharing feature with the operator is seen as an incentive for the operator to price the *tabarru’* of the *takāful* product prudently. There is an underlying expectation from the regulator in Malaysia that the *wakālah* fee is to cover the operators’ expense, while the share of underwriting surplus is the profits the shareholders are entitled to for putting up capital in *takāful*. Allowing the shareholders to share in the underwriting surplus goes some ways towards aligning the interests of shareholders with those of the participants. It would seem, then, that the Sharī’ah scholars in Malaysia are comfortable with this modification to the *wakālah* model, but we see significant resistance in the Middle East to the extension of the *wakālah* contract type to include surplus sharing. However, before taking this difference in interpretation of what can be done in a *wakālah* contract as a significant issue in *takāful*, it should be recognised that, from the shareholders’ perspective, underwriting surplus is not seen as a dependable source of income should there be intense price competition in the marketplace.

## Key Challenges Facing *Takāful*

### ***What Insurance Risks Can Takāful Undertake?***

Insurance is a complicated business. It is also a heavily regulated one. It involves a relatively high number of transactions per dollar of premium and therefore is system intensive. Insurance is sold, not bought, and thus building and maintaining a large distribution force is key to the success of an insurance company. It is pertinent to note that the financially

successful insurance companies in the world have been operating for decades. There is a reason for this. New entrants to the market find it very difficult to compete with the established players, as these established insurers have built up over time, or through multiple acquisitions, an extensive infrastructure such that they can do the business efficiently and with minimal risks. Established insurers that have “tripped up” are mainly those that went through unsuccessful mergers and acquisitions in an attempt to grow inorganically. Size is nearly everything in insurance.

Into this market have entered the new *takāful* operators. Many of these new operators were expecting that Muslims would rush to use their services. That has yet to happen. We see many *takāful* operators struggling to achieve scale after nearly a decade of operation. There are also *takāful* operators still facing operational and system issues many years after their start-up. Firefighting internal issues diverts precious resources away from the work that is more productive – that of achieving scale and making the business a success.
















To have a chance of succeeding, *takāful* has to recognise its limitations. It is not naturally suited to some classes of risks. It needs first to examine the market it intends to enter. It has to consider what the drivers of success are for each class of business.

Insurers compete for business through:

- products;
- service (e.g. easy and fast claims settlement);
- accessibility (e.g. number and spread of agents/intermediaries); and
- level of premium rates.

Table 4.1 analyses the importance of service, accessibility and level of premium rates for different classes of insurance products from the perspective of the potential insured (the shaded area representing the level of importance).

**Table 4.1: Importance of Service, Accessibility and Rates for**

	Term Life	Motor	Medical	Property (retail)	Property (commercial)
Service					
Accessibility					
Level of premium rates					

### Various Lines of Insurance

The *takāful* operator would need to assess, given its strengths, in which of the classes of business shown in the table it has a fair chance of success given the existing competition.

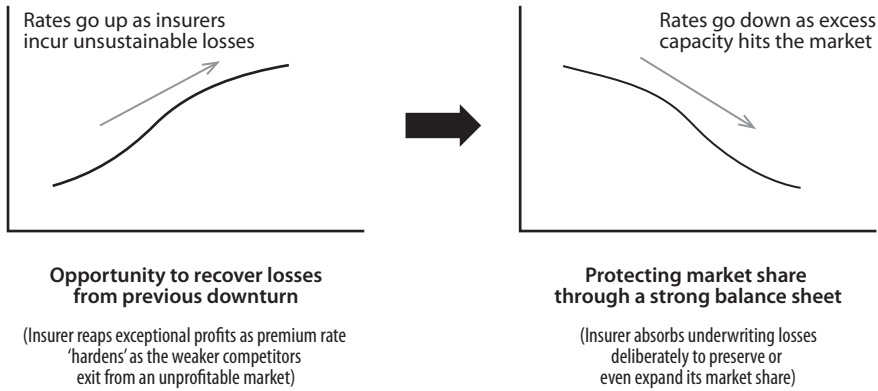
For life insurance there are two components: protection and savings. We can say with some confidence that there is sufficient capacity (whether direct or *retakāful*) for *takāful* operators in most markets to undertake protection cover. Term life is purely protection; what is perhaps most important is distribution (accessibility), as there should be a natural demand for protection products for the family. As claims would not be great in number, the service aspect for term *takāful* is not as important. Term rates are relatively “cheap”, so the level of premium rates should not be an issue. Similarly for the savings component of life insurance, distribution is the driver of success. For *takāful*, there is also a need for access to a secondary *ṣukūk* market, as participants would require some stability in their expected return when they save through *takāful* products. Life *takāful* (more often called “family *takāful*”) would be a natural product for start-up *takāful* operators as long as there is good distribution and a liquid *ṣukūk* market. In the absence of a *ṣukūk* market, the *takāful* products would need to be suitably modified so as not to result in unacceptable asset–liability mismatching risk.

Health insurance requires significant expertise to make it work. It involves managing medical claims that include managing health service providers. It is unlikely that a start-up *takāful* operation would be able to have the necessary infrastructure to manage this class of business without facing significant operational risks. It may also be imprudent to fully outsource such services, as this can result in runaway claims experience, particularly as a result of the inevitable delay in monitoring claims experience caused by using an external service provider and the lack of alignment of the financial interest of the participants’ pool and that of the third party administrator.

General insurance can be classified under personal or commercial lines. In many countries the bulk of the net insurance premiums are from the motor and fire class. Competition in these classes can be intense. For such commoditised products, the successful insurers are those that have low expense per unit insured. It is not recommended that a start-up *takāful* operator base its business plans around such products, as the market share is usually determined by which insurer offers the lowest rates.

In a liberalised market where insurers are free to set their rates, *takāful* operators will find themselves at a disadvantage. Figure 4.7 considers one underwriting cycle and the possible impact on the financial results of an insurer.

**Figure 4.7: The Underwriting Cycle**



In such a market the *takāful* operator will be at a disadvantage because of its operating model, specifically the need to share underwriting surplus with the participants. Table 4.2 elaborates on this by showing the share of the income to the shareholders in an up market (on the assumption of a limitation on the operator's share on underwriting surplus and investment income of 50%).

**Table 4.2: Shareholders' Share of Income**

	<i>Takāful</i> operator ( <i>wakālah</i> on contribution with profit sharing on investments)	General insurer
<b>Underwriting surplus</b>	50% (max)	100%
<b>Investment income on technical reserves</b>	50% (max)	100%
<b>Expense underrun profit</b>	Limited by <i>wakālah</i> fees	100%

However, in a down market *takāful* shareholders need to provide capital support as the *takāful* operator is forced to provide a discount on its rates to ensure participants renew their policy. This injection of capital to the participants' pool is no different from a general insurer transferring capital to the policyholders' funds, except that in *takāful* this capital injection is designated as a loan from the shareholders, an accounting entry, but to all intents and purposes having the same effect on solvency as a shareholders' capital transfer. General insurers are thus able to accumulate operating reserves faster than a *takāful* operator, making them stronger to withstand the subsequent downturn in the underwriting cycle.

## Role of the Sharī'ah Board and the Risks It Imposes

No one would deny that Sharī'ah compliance is an important driver of *takāful*. Islam personifies a “way of life”. It is not limited simply to guiding Muslims as to how they should complete their obligations under the five pillars of Islam, but also as to how they go about their daily lives, which includes how they conduct their businesses. The basis of Sharī'ah scholars' fatāwa, or rulings, starts from the Qur'ān and continues on with the Sunnah (the verbally transmitted record of the teachings, deeds and sayings of the Prophet) and then extends to the consensus of scholars of the previous generation (on the basis that being closer in time to the Prophet, they are more enlightened to give a fatāwa), and finally to using logic and reasoning to come to the best ruling. Sharī'ah scholars, however, are not infallible; no humans are. There is a risk that giving too much “power” to Sharī'ah scholars to decide on issues arising in insurance would disrupt the market. The need for a clear set of rules in insurance is why, in any country, a uniform set of insurance regulations would have been imposed on the market. It would be preferred; therefore, if similarly a standard set of Sharī'ah rulings were to apply to all *takāful* operators in any one market. In Malaysia there is a central Sharī'ah board, the Sharī'ah Advisory Council of Bank Negara Malaysia (SAC BNM), which was established as the highest Sharī'ah authority in Islamic finance in Malaysia.

*Takāful* operators have their own Sharī'ah Supervisory Boards (SSBs), but all such “local” advisory councils are by law required to accept the decisions of the SAC BNM. There have been decisions of the SAC BNM which were questioned by *takāful* operators' own SSB, but there has not been any public dissent in regards to the SAC BNM fatāwas on *takāful*. Why the need to have “local” SSBs? In addition to providing guidance on issues pertaining to *fiqh mu'amalat* (Sharī'ah law that applies to rulings governing commercial transactions between parties), the SSB is also responsible for ensuring that the *takāful* operator is being run in a Sharī'ah-compliant way. It is similar to offering *halal* food for Muslims or *kosher* food for Jews in a food outlet; the preparation process must adhere to certain standards before it can be certified as *halal* or *kosher*, respectively. For *takāful*, this can include how its employees dress for work (you need not be a Muslim to work in a *takāful* company, but non-Muslim employees are also expected to dress to a certain standard) and how employees interact with the participants. The SSB is responsible for setting the Sharī'ah standards for management to implement and to monitor that those standards are adhered to. In some jurisdictions there can be a ruling that a member of one *takāful* operator's SSB cannot at the same time also be an SSB member of another *takāful* operator. This is consistent with a similar requirement that applies to members of the board of directors of *takāful* operators. An SSB member can, however, also be a member of the operator's board of directors.

In Malaysia the SSB can contain up to five members, the majority of which must have credentials in *fiqh mu'amalat*. This means up to two members of the SSB can be professionals

(e.g. actuaries, lawyers and accountants). This is a practical requirement, as the SSB may not have adequate knowledge when the issue to be decided on by the SSB is technical in nature. An actuary on the SSB would, for example, be able to explain to the other SSB members how surplus is apportioned among participants so that the SSB can rule whether the basis of apportionment is Shari'ah-compliant. It is apparent that the SSB plays a major role in *takāful* and the risk of making a wrong *fatwā* on a product or an investment of the *takāful* operator would have to be high where the SSB members are entirely dependent on management for guidance on technical questions. From a corporate governance perspective, this is similar to the need for the majority of directors to be independent of management when arriving at the board's decisions.

One question that needs to be asked is whether different *fatāwas* on the same or similar issues given by competing *takāful* operator SSBs can result in market disruption? Indeed, they can, but this risk is minimised by the presence of the central SAC, which can rule when there are disagreements between operators' SSBs. Alternatively, the central SAC or regulator can avoid the conflict by providing guidance to SSBs on major technical issues. These guidelines can be considered as restrictive initially, but such guidance can be lifted over time as the members of the SSB become more acquainted with the technical issues surrounding *takāful*. Two major technical subjects that would benefit from a national policy are those governing product design and investments – the former, as this has the greatest impact on the *takāful* market; the latter, as this plays a big role in determining what the participant can expect from saving through *takāful*.

From a governance perspective, it would also be appropriate for the SSB decisions to be regularly subject to external review. In some jurisdictions, there is a requirement to do a Shari'ah audit annually or at specific durations. This audit would cover the whole operation, not just the decisions arrived at by the SSB. A concern is that intense competition between *takāful* operators can result in deterioration in the standard of *fatāwā* generally, as there can be significant room for the exercise of discretion among Shari'ah scholars in arriving at a *fatwā* depending on the particular circumstances of the operation. For example, we have experienced the exasperation of a marketing executive of a *retakāful* operator when the actuary of a *takāful* operator requested guaranteed mortality *retakāful* rates, saying that the *retakāful* operator's competitors provide such rates. As this executive has already been told by his company's SSB that there is no question of providing long-term guarantees in *retakāful* rates, as *takāful* is about risk sharing rather than risk transfer, this has resulted in some confusion. Unless there are guidelines from the regulator or the central SAC on this issue, it may be only a matter of time before the SSBs of all *retakāful* operators decide that providing long-term guaranteed *retakāful* rates is permissible on the basis of '*urf*' (custom or market practice) and/or on the basis of ensuring that the firm will continue to operate in Malaysia.

## Market and Liquidity Risks

In insurance, premiums are paid before claims are paid. Asset and liability management is therefore an important component of ERM. For insurance, unlike *takāful*, there is usually a greater range of asset classes available for investment and a deeper secondary market in which to trade for most of these assets. Traditional life insurance products such as endowment assurance provide a guaranteed benefit at the maturity of the policy. Under a risk-based supervision regime, the insurer has a choice of providing this guarantee on the basis of the strength of its balance sheet (which requires a higher amount of risk-based capital) or, alternatively, investing the premiums in assets that “match” this liability. This matching can be primarily from a return and cash flow perspective, or the asset class itself can also include a capital guarantee at redemption. As shareholders will seek to secure the greatest return on capital employed, it would be discouraged to design products that require significant capital (solvency) support. It is understandable, therefore, that insurers would either avoid selling guaranteed endowments or ensure, before providing any guarantees that they can invest in assets of suitable durations and with similar capital guarantees. It is therefore to be expected that the majority of assets of insurers consists of investments in fixed-income securities.

*Takāful* operators in many jurisdictions have a very limited number of asset classes they can invest in (see Box 4.4). In the MENA region, for example, investment in equities and real estate make up most of the non-deposit investments. This can be a serious mismatch between the *takāful* operators’ liabilities and the corresponding assets. It would be interesting to observe what will happen when the region moves to risk-based capital supervision. To minimise market and liquidity risk, the *takāful* operator would need to confine its investments to deposits in Islamic banks as the *ṣukūk* market in the MENA region is limited and illiquid. This can put *takāful* operators at a disadvantage compared to insurers when competing on price.

### Box 4.4: Sharī’ah-compliant Assets and *Takāful* Products

Insurance involves investing money, as premiums are paid before cover is granted. When a savings component is present in the insurance policy, the insurer is entrusted to return some of the premium together with interest/profit. The insurer may also guarantee what this interest rate would be. Given that insurers invest primarily in the secondary capital market due to liquidity concerns, asset and liability management is a crucial part of risk management for an insurer.

A Sharī’ah-compliant asset class is a subset of the global investment opportunities available to insurers. A crucial asset class for insurers is the bond/fixed-income market. Bonds provide certainty of cash flows and returns, which are necessary to match the insurers’ own payment obligations. Asset–liability mismatch risk is a significant risk that insurance regulators monitor. *Takāful* funds do have *sukūk* as an alternative to bonds, but their availability is limited and liquidity is uncertain. *Takāful* operators should therefore avoid designing products that are dependent on any guarantees on capital or profit.



## Family *Takāful* As a Savings Aggregator

Life insurance companies can grow to boast a significant balance sheet. (For example, New York Life, a mutual life insurance company, has over USD 500 billion of assets under management.<sup>66</sup>) This has come not from accumulating past profits (these profits would have been mostly distributed as dividends) nor from shareholders' capital; rather, it has come from accumulating the savings of policyholders through underwriting life insurance and annuity products. Family *takāful* can take on that role of a savings aggregator. The difference between savings in an Islamic bank and in *takāful* is that the latter usually takes the form of a structured savings programme aimed at saving for a particular event, such as retirement, and usually as regular monthly or annual contributions. As a result of this programme, the tenure of investment through *takāful* is also usually longer than in an Islamic bank (usually more than one year). The investments made by the *takāful* operator from these contributions have to be Sharī'ah-compliant.

From a risk and governance perspective, there is a need to ensure that participants are aware of the nature of the assets that are being invested – in particular, the liquidity and volatility of the asset class – and that the features of the asset class are compatible with the participants' risk appetite and expected duration for investment. This is of particular concern, as the participant does not “own” the assets; rather, it “owns” the *takāful* contract. The participant therefore needs to be aware of any charges that may be imposed should he prematurely terminate his contract. Certainly, money aggregated from family *takāful* and annuity contracts can be invested for a longer duration and is an ideal source of capital for investment, through suitable capital market instruments, in Sharī'ah-compliant businesses, properties and long-term infrastructure projects, emphasising the important role of *takāful* as the third “leg” in the three-legged Islamic finance “stool”, the other legs being Islamic banking and Islamic capital markets.

## What about *Takāful* Windows?

There are two aspects to *takāful* windows: Sharī'ah and business. From a Sharī'ah perspective, *takāful* windows are only a temporary dispensation from setting up stand-alone entities. Malaysia never had *takāful* windows. Indonesia started with *takāful* windows and has plans to move to stand-alone *takāful* operators. Pakistan and Turkey are quite happy to have a market where *takāful* windows and stand-alone *takāful* coexist. There is much to be discussed about the pros and cons of *takāful* windows as opposed to *takāful* stand-alone that require a separate paper in itself. From a risk and governance perspective, *takāful* windows present additional risks and corporate governance challenges which can be summarised as follows:

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66 <http://beta.fortune.com/fortune500/new-york-life-insurance-61>.

- (i) In a window, *takāful* is just another product for the company. As “another product”, conflicts will abound – for example:
  - a. Concerns about cannibalisation of the more profitable (from a shareholder’s perspective) insurance products preventing the *takāful* window developing past a certain stage.
  - b. Allocation of marketing efforts between *takāful* and insurance. Which products should management give priority when marketing? This is especially true when the company is operating in a Muslim-majority country.
  - c. Allocation of Shari’ah-compliant assets. (Insurers do also invest in Shari’ah-compliant assets.) For example, if a particular Shari’ah-compliant asset is desirable for both *takāful* and insurance, where would management allocate this asset?
  - d. Allocation of expenses between *takāful* and insurance businesses. Due to the different way in which expenses are offset in *takāful* and insurance, allocation of expenses affects shareholders’ profitability differently, giving rise to governance issues.
- (ii) Greater misselling risks, as the same sales workforce/distribution channels would probably be used for *takāful* and insurance and the understanding of *takāful* may be limited among many sales staff.
- (iii) Would assets be physically or notionally separated between the window and insurance? Notional separation raises issues on any winding-up.
- (iv) In any winding-up, how would the *takāful* window be treated?

There is also the market risk. The public need to appreciate the differences between a window operation and a stand-alone operation, and this is usually not apparent. If a Shari’ah scholar were to be asked whether he would buy from a *takāful* window or a *takāful* stand-alone, it is highly likely he will choose the latter. Would the purchasing public care? It is also likely that a similar *takāful* plan is “cheaper” in a *takāful* window as compared to a *takāful* stand-alone (see Box 4.5). If price is a major consideration, a *takāful* stand-alone would be the “loser”. From the perspective of the long-term development of *takāful*, the government would need to decide how it envisages Islamic finance developing over the long run. If the national policy is to have an independent Islamic finance industry, then promoting the stand-alone *takāful* model would ultimately be the best approach to pursue.

#### **Box 4.5: *Takāful* Window**

*Takāful* windows are usually set up by already well-established insurers. They carry the advantage of avoiding the business risks associated with new stand-alone start-ups, as the cost of setting up windows would only be marginal from the shareholders’ perspective as most of the existing insurance infrastructure can also be used for *takāful* products. This also means that *takāful* products can be “cheaper” than those from stand-alone *takāful* operators and be more competitive with established insurance products.

## Conclusion

To recap, the brief of this chapter was to share “various governance structures that have been proven to be effective in managing the risks in *takāful*”. The author hopes that he has achieved to highlight the various risks that the *takāful* operator needs to consider. Risks can be generalised into two types: inherent risks, which are risks that cannot be avoided and, if taken, must be properly managed; and operational risks, which can be reduced or eliminated completely.

Inherent risks arise from each of the following decisions made:

- The reasons why investors choose to invest in *takāful*. An investor focusing on chasing profits is likely to take on board more risks than an investor committed to the *takāful* principle.
- The operating model chosen. For example, a *muḍārabah* operating model carries with it a different set of risks as compared with a *wakālah* operating model.
- The *takāful* products to underwrite/promote. Certain products are more suited to *takāful* start-ups than others. Choosing the wrong products can be financially disastrous.
- How the *takāful* operator is positioning itself in the market. Trying to succeed by having the cheapest product is unlikely to be sustainable over the long term. Product and service differentiation may be slower to generate top line but is more likely to result in a satisfied consumer base.
- When the regulator issues too many *takāful* licences when the demand is not there and/or the trained and experienced human capital is lacking.
- When the regulator issues regulations that do not sufficiently differentiate *takāful* from insurance.

The author would conclude that much of the risk that is associated with *takāful* can be addressed by jurisdictions carefully screening applications for a *takāful* licence for suitability, and by recognising that the *takāful* business/market is different from insurance. The insurance market works on the basis of “price discovery through competition”. This is the same basis that other business operates on, be it selling cars or selling pencils. However, unlike cars and pencils, insurance is selling a service and the “buyer” in many instances is not able to assess the value of this service unless he eventually makes a claim. This added complexity requires that the regulator manages the competition between insurers. With competition, the weaker insurers are likely to fail and it is important in such markets that there be a mechanism with which insolvent insurers are wound up with minimal impact to policyholders.

As mentioned earlier in this chapter, the insurer is taking on speculative risk; he is putting his capital at risk in order to “win” profits. The *takāful* market is not the insurance market. There is no “capital” in *takāful*. The shareholders of the *takāful* operator are there to extend a loan to the participants to manage claims volatility, but the loan must be repaid. It makes no sense for *takāful* operators to compete with insurers on rates, as the two business models are different. We see cooperative businesses in farming, supermarkets and banking, for example, and the user–owner business model is geared to providing better services and value to its members. Yes, the price of goods in a cooperative supermarket may be lower than that of other supermarkets, but that “discount” has been achieved through the combined efforts of the members of the cooperative and the savings passed on to the consumer. The author would submit that *takāful* can be “cheaper” than insurance, ultimately, but it cannot be cheaper and be financially sustainable if it tries immediately to compete on price with insurers in the insurance market. *Takāful* also needs scale to succeed, and that takes time. Too many *takāful* operators in a market makes the task of achieving scale more difficult, and is also detrimental to the orderly development of the *takāful* industry if operators compete primarily on price.

The risk and governance process for *takāful* needs to be considered on a holistic basis. Indeed, we should not be talking about starting *takāful* businesses but instead about building a *takāful* market. The two are different. Allowing *takāful* to operate like insurers will, in the author’s opinion, only result in Sharī’ah-compliant insurance companies, not *takāful* operators. The consumer outcome will not be very different under the Sharī’ah-compliant insurance model. Should this happen, we would then lose the opportunity to offer a differentiated consumer experience to the public, whether Muslims or otherwise. We are now in an era of Ubers and Airbnb, a taxi company with not a single taxi and a hotel chain with not a single hotel room. Can *takāful* not make a difference?

# CHAPTER 5: CHALLENGES OF *RETAKĀFUL*: THE LIMITATIONS OF COOPERATIVE REINSURANCE AND ITS SOLUTION BY TECHNICAL ANALYSIS

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**Dr. Ludwig Stiffl**

## **Introduction**

It would, in our humble opinion, be difficult to say that *retakāful*, particularly general *retakāful*, is doing well. After small beginnings and a wave of incorporations a decade ago, the industry is in retreat again; some operators have closed, some are downsizing or changing to a “window” approach, while some seem to have refrained from entering the non-life business from the start. There are peculiarities of the reinsurance business that certainly play a role in this experience, and the Islamic Financial Services Board’s IFSB-18: *Guiding Principles for Retakāful (Islamic Reinsurance)* spells out these points: that is, the fact that it is an interprofessional business (IFSB-18, paras 27, 29, 33); and that it deals with complex, special, large and capital-intensive risks (para. 28.iv). The implementation of a risk-sharing approach (however it shall be defined) in this environment raises questions by cedants trying to market *retakāful*. They include: With whom will my portfolio – and its potential surpluses – be pooled? Can I estimate the outcome of a treaty I am signing? What impact has a *qard* on my results? Is it a liability on my balance sheet? These questions form the challenges in organising and marketing *retakāful* and they originate in problems of making the reinsurance business compatible with risk sharing and the cooperative idea.

*Retakāful* being cooperative in principle, this chapter starts with an example of cooperative (in fact, as we shall define it later: mutual) reinsurance from outside the Islamic world, which may help in elucidating the issues we encounter. Thereafter, it outlines other models of mutuals and then discusses the issues that arise in applying IFSB-18 in reality.<sup>67</sup>

## **Methods Of Organising Cooperative Reinsurance**

*Retakāful* is supposed to function in analogy to *takāful*, where the risk is kept within the pool of participants (risk sharing, rather than risk transfer). All *takāful* companies, in turn, are not mutual; rather, in one way or another, they are hybrids of cooperative funds and shareholder companies. Their recurrent challenge is to maintain a cooperative nature and behaviour under this hybrid structure, a task that creates a number of dilemmas. For *retakāful*, as we

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<sup>67</sup> Throughout the chapter, the author contrasts and enhances his views with those expressed by his co-discussant, Peter Casey, during the panel session and before.

shall see, these dilemmas are multiplied compared to the direct companies and, until the principal dilemmas are resolved, will seriously impede development.

If we look at the Western world, cooperative insurance is widespread on the direct side, with about a quarter of the total premiums, but the companies are mutuals without shareholders, not hybrids. Now, are there reinsurance companies or mechanisms that work on the same, cooperative principles? We should maintain that there are several ways to organise risk sharing – namely, pool agreements, syndicates, and gentlemen’s agreements based on long-term partnership. These techniques are more or less known, but there are very few mutual reinsurers. To start with the most unusual example, the characteristics of a mutual reinsurer shall be scrutinised now, using the example of Kieler Rück, based in northern Germany.

## A Mutual Reinsurer

Kieler Rück, founded in 1922 for and by the mutual insurers of the largely rural, most northern federal state of Germany (Schleswig-Holstein; the company is named after the state’s capital, Kiel), has the following features:

- (i) It is a mutual company according to the German Insurance Law and an association.
- (ii) To become a cedant, a company must first become a member of the association and sign its statutory agreement.
- (iii) Members are obliged to make injections in the case of a deficit in the annual reinsurance account and have the right to receive surpluses.
- (iv) Only mutual insurers from the state of Schleswig-Holstein can become members.
- (v) Residential fire, comprehensive housing and home-owner lines of business make up about 85% of the premiums.
- (vi) Despite the concentration on low-volatility individual lines of business, the retrocession ratio is 75%. (The region is wedged between two seas and is prone to storms and high tides.)
- (vii) About half of the balance sheet amount (which is less than €20 million) consists of retained profits (own funds) and an equalisation reserve – that is, “free reserves” – that will be distributed to the members in the case of a winding-up.

Given the structure of Kieler Rück’s portfolio, it can best be described as a small insurer and – in view of the 75% retrocession ratio – more as a joint reinsurance department for the members than as a risk pool. From a theoretical view, it is largely a cooperative for consumption – consumption of reinsurance capacity.

The common issues that arise in comparing Kieler Rück to IFSB-18, section B.VIII, “Special Issues in *Retakāful*”, are shown in Table 5.1.

**Table 5.1: Mutual Techniques According to IFSB-18 and Kieler Rück, Germany**

IFSB-18	Kieler Rück
Professional participants	Yes, but only mutuals
International	Regional, not even national
Large and specialised risks	Individual risks and some Natural Catastrophes
Capital-intensive	High retrocession ratio
Sharī'ah-screening, <i>Ribā</i>	Not applicable
Intragroup cessions	Injections
Commissions and brokerage	Important (due to high retrocession), not an issue for the fund segregation, since there is no shareholders' fund
Run-off rules	Yes
Supplementary services	Reinsurance "department" for members
Additional: <i>Qarḍ</i> ( <i>ḥasan</i> )	Injections by members
Diversification	Homogeneity
Surplus distribution	Yes

Kieler Rück's mutual approach shows one of the dilemmas of cooperative reinsurance. It is the problem of agency and opportunistic behaviour, which is clearly solved in this example by the formal membership and the obligation to make injections for deficits (where Islamic insurers take *qarḍ* from the shareholders). The dilemma of this clear solution is that it requires the reinsurer to limit its market to a very small number of homogenous cedants/members, *who know each other perfectly well* and can thus commit themselves to making injections.<sup>68</sup>

This mutual approach leads to serious economic limitations, which are also mentioned every year in Kieler Rück's annual reports: no diversification gains (neither geographically nor by branch/risk), lack of economy of scale, and law of large numbers. (This is explicitly mentioned in the forewords of the company's annual reports.) Both effects make the high retrocession ratios necessary, which effectively means that the risks are not shared between the participants but are transferred to the reinsurance market – jointly transferred, but still transferred. It would be worthwhile for regulating bodies to scrutinise the question of whether it would be possible to transfer this set-up of a mutual reinsurer in a way that avoids the downsides it involves – in particular for Islamic reinsurers (knowing that risk transfer is not forbidden for this German company, but that for *takāful* it is).

<sup>68</sup> The author had the same experience when starting a *retakāful* business in Malaysia, where the first question clients asked was: "With whom will we be pooled?"

## Other Forms of Mutuality and Solidarity in Reinsurance

### **Pools**

Looking at these characteristics, we find that quite close to a mutual reinsurer, and much better known in Africa and Asia, are reinsurance pools, as well as P&I (protection and indemnity) clubs in marine insurance (cf. IFSB-18, para 5, fn 4). As in the above example, they are limited to certain sorts/lines of risk and to a particular region, so that all the members know each other. In turn, they agree to share the risk of deficit among themselves. The *retained* risk, we need to add, because the more important function of such pools is to cede out the larger part of the risk assumed to the international market, just as Kieler Rück does. The difference is mainly that the pool is not a legal entity, but rather, in many cases, an entity operated by the national reinsurer, who nevertheless does not take on the risk of deficit (not in his capacity as the operator, at least) and is thus close to a *wakīl* (agent) in an Islamic set-up. The difference from a *takāful* operator in the role of a *wakīl* is that they are not limited to organising this pool and do not have to make their living from this alone (or do not take any compensation at all). At this juncture, we should like to remark that we do not know of any Sharī'ah ruling that explicitly forbids a *wakīl* to serve more than one fund. Once the questions of confidentiality and alignment of interest are solved (which would, in our opinion, imply Sharī'ah relevance), such a multi-fund/multi-line operator could be an out-of-the box solution.

### **Syndicates**

Another related structure is reinsurance syndicates, mainly due to their concept of managing agents (see IFSB-18, para. 5). It is logical that the Global Takaful Group tried in 2008/9 to create a *retakāful* syndicate at Lloyd's. The problem here, and probably a reason why this project has not been realised, is that such syndicates explicitly aim to transfer the risk to the members, and we will be back in the same dilemma unless these members are (a), Islamic, (b) willing to take on the deficits in solidarity despite the agency issue, and (c) ideally, identical to the ceding companies/*takāful* pools.

### **Informal Mechanisms of the Conventional Reinsurance Market**

This is not a black-and-white world. Whoever observes international reinsurance practices knows that, just as *takāful* is not an island of altruistic solidarity, the conventional world is not 100% driven by cut-throat opportunism. There is a limited number of reinsurance providers, who have been around for decades, even centuries, and who derive their success from their reputation and reliability. All cedants – in particular, the relatively small companies in the Islamic world – need to make sure that they will have access to capacity and know-how in the long term that avoids the risk of mixing assurance and insurance. This leads to a market where agreements on long-term relationships and compensation business for large losses, ex gratia payments, etc., are very common and, although usually bilateral between



insurer and reinsurer and not on a pool basis, demonstrate a solidarity mind-set. Moreover, regulators, insurance federations or personal relations can have a disciplining impact on the conduct of companies, for the sake of the reputation of the market. Such methods might be used and considered in regulations – for example, when it comes to increasing the probability of repayment of *qard*.

**Table 5.2: Summary of Theoretical Mechanism of Joint Risk Acceptance/Sharing**

	Membership (of cedants)	Geographical, etc., homogeneity	Risk sharing (injections)	Exclusivity of agent/ <i>wakīl</i>
<b>Mutual reinsurer</b>	Closed	Yes (agency issue)	Yes, but only on retention	Yes
<b>Pools</b>	Closed	Yes	Yes, but only on retention	No
<b>Syndicates</b>	Open	No	No, transfer is the aim	No
<b>Informal</b>	Open	No (bilateral)	Yes, bilateral	No
<b><i>Retakāful</i> operators</b>	Open	No	<i>Qard</i> ?	Yes

## The Dilemmas: The Guiding Principles Compared To Practical Experience

### ***An Overview of the Structure and Purpose of IFSB-18***

The content of the Guiding Principles in IFSB-18 reflects the concerns of regulators. Peter Casey, during the preparation of this book, gave his own version of those concerns as follows:

*The first concern of an insurance regulator, whether the insurance is conventional or Islamic, is always that the money should be there to pay valid claims. This is a still more dominant theme for the regulator of reinsurance or retakāful, the customers for which are by definition insurance/takāful undertakings, bringing a higher level of understanding and negotiating power than the typical client of a direct insurer or takāful undertaking. But ensuring the money is there is not simply a matter of setting a capital requirement, however sophisticated. It involves looking at business models, behaviour and incentives. In addition, there are in the conventional world many examples of techniques used to mislead regulators or markets about the true financial position of a firm.*

*In the case of takāful, a regulator can, and in my view should, also take an interest*

*in whether the explicit or implicit claim to be Sharī'ah-compliant is well-founded. This is a key representation to the takāful undertaking's customers. While this is dominantly an issue for the regulators of direct takāful, the concerns of a religiously-sensitive customer are unlikely to stop at the first stage of the transaction. If, in the extreme, a takāful undertaking is effectively "fronting" the business for a conventional reinsurer, whose business model, investment policy, etc. do not conform with Sharī'ah, it is difficult to see how this can be presented to the ultimate client as Sharī'ah-compliant. Hence the takāful regulator has an interest in Sharī'ah compliance up the chain (and may of course take comfort from good regulatory provisions where the retakāful undertaking is located).*

While going through the table of contents of IFSB-18, it is noteworthy that a very large block (paras 35–88) is dedicated to Sharī'ah, governance, faith, honesty, etc., which have no direct technical (financial/numerical) impact and will thus not be dealt with in detail in the following.

**Table 5.3: A Brief Schematic Overview of the Technically Relevant Themes**

Structure of IFSB-18
• Agency issue and alignment of interest (paras 36–43)
• Contract clarity in an open pool
• Risk sharing and risk transfer
• Technical and juristic principles (12, 18, 28)
• Pricing issues (27); Commissions (28)
• No direct technical relevance (35–88)
• Ring-fencing and diversification effects (99, 102–103)
• Capital management and retrocession (24–25, 28.vi–viii)
• Liability-based investment policies and methods (95, 109–114)

### **Agency Issue and Alignment of Interest**

The 2013 International Islamic Fiqh Academy (IIFA) resolution stated that an Islamically legitimate insurance business cannot be for profit. But since Islamic mutuals have not yet been founded, the *takāful* operators are shareholders' companies (Sudan may partly be a special case) and are allowed to aim for profit. That is the basis of the dilemma. As we will discuss below, it is doubted that *takāful* operators really do share insurance risk and, even if this were the case, it is still doubtful whether it is in the interest of the participants if the operator has "no skin in the game". That is the reason why many Sharī'ah boards allow performance fees. But even if there were no risk transfer at all, the shareholders have interests and the question as to what extent they behave in an opportunistic way is

crucial when drafting any regulations or guidelines. In *retakāful*, it becomes even more complicated, since the cedants' operators may feel compelled or obliged to defend the interests of their shareholders' funds as well as those of their respective participants' funds. It is a sound assumption – and in line with *fiqh* tradition – that one shall not blindly trust in an Islamic value behaviour of the operators. Since most of the principles outlined in IFSB-18 aim at disclosure, transparency, contract clarity, etc., one can say that the IFSB – rightly – works on this prudent assumption. And if, thus, the operators worldwide do not work as an especially altruistic community, the principle identified above holds true – namely, that solidarity and risk sharing only works between like-minded people who know each other and the other's business and also, ideally, have a common interest. Even under these circumstances, contractual documentation of the obligations would be preferable.

### **Contract Certainty in an Open Pool**

By an "open pool", we intend to describe a *retakāful* risk fund (RRF) where, unlike in the mutual example above, the cedants enter by virtue of concluding their *retakāful* treaty only, which is formally with the rest of the pool but, in practice, the negotiating and contracting partner is the *retakāful* operator ("deputising" the RRF, as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) says – "*niyaban 'an*"). There is no additional association deed (even, as far as we know, in those companies that work on a *waqf* basis). The important point is that the cedants do not know who is already in the pool with them and who will join; neither do they prescribe any particular underwriting policy to the *retakāful* operator.

Although paras 61ff. of IFSB-18 intended contract certainty in the narrow sense of arriving at a definitive legal contract, the concept can also be understood in a wider, operational way. In case there is a real pooling of surpluses and deficits, contract certainty, as well as the economic planning of the operators, is affected by the unknown underwriting policy of *takāful* pools from anywhere in the world. In addition, it turned out in practice that the calculation, and thus the payment, of surpluses and deficits can take quite a long time if the operators have to wait for the client with the longest-running member of the portfolio to develop. These are the economic reasons that led to the creation of the so-called one-client funds, in the Malaysian terminology (see below, when we talk about profit commission). But, even more important than these – in our opinion, legitimate – economic and operational obstacles is the intrinsic contradiction which, in the end, originates in the application of the *tabarru'* concept to profit-orientated operations. If the operators forfeit the economic results of their *retakāful* treaties (including repercussions on the *qard* they might pay), it poses a serious obstacle to the business's economic viability. If they limit the pools to participants who know each other, it hinders growth, as in the German example above.<sup>69</sup>

<sup>69</sup> A technical solution to this is provided later in this chapter.

## Risk Sharing and Risk Transfer

### Definition of Risk Sharing

IFSB-18 starts, as mentioned above, with aptly pointing out the main difference (para. 4.ii), and the particular differences in the nature of the business, between direct insurance/*takāful* and reinsurance/*retakāful*. It also mentions the main difference between reinsurance and *retakāful* – namely, that *retakāful* is based on risk sharing (para. 4.ii). But at that point, one had expected to have a more precise definition of what risk sharing is in essence and how it can be measured. Even when neglecting, for the moment, the “soft” spiritual dimension and concentrating on technical facts, the reader can only surmise from different places in the text what is understood by it – for example, that the operator does not take on any underwriting risk (para. 20). We first doubt that this latter point always reflects the reality, and we think in particular that the *retakāful* conundrum, which hinders marketing and growth, cannot be solved unless the definition of risk sharing is drawn down to the extent of being measurable at the accounting and financial reporting level. It is noteworthy that in respect, that the explanation of reinsurance forms and techniques in IFSB-18 (namely, para. 27), at no point mentions where these conventional techniques need to be adapted in a *retakāful* environment. This is discussed in the latter sections of this chapter.

### Technical and Juristic Issues

In general, risk transfer is the main service required from the reinsurer. Therefore, the issue of whether risk sharing actually works – in particular, in (general) *retakāful* – and the closely related question of the appropriateness of *qard* already has a longer and quite famous history. Stiffl (2011b, confirmed, for example, by Papp, 2014: 41) asserts that in high-volatility business – and that is typically in non-life reinsurance – deficits should occur regularly. The opinion that this represents a breach of the risk-sharing principle was later acknowledged by others (cf. Abu Umar, 2015: 128). Also, IFSB-18 mentions capital intensity under the special features of *retakāful*. The IFSB earlier proposed to solve the problem by introducing the *qard* facility. But there are still a number of problems, also from a *fiqh* point of view, namely:

- (i) *Qard* should be voluntary in provision but obligatory in repayment; while, for the cover to function and to be marketable, payment must be obligatory and repayment at least contingent on the occurrence of surpluses (see IFSB-18, paras 82 and 102, which forbid withdrawal of the facility). We think, by the way, that this difference is a main reason why the Malaysians call it *qard*, to differentiate it from *qard hasan*. That, on the other hand, would be an innovation in *fiqh*.
- (ii) It may be worth mentioning that, according to the author's research (Stiffl, 2016), *qard* was not part of the original *takāful* set-up, but rather a “quick fix” introduced by the late Sheikh Dharir for cases he probably deemed as being rather exceptional.

Perhaps it is a constructive development in the system of *takāful* if we look for replacements of *qard* in settings where it turns out to become the rule.

- (iii) During the discussion of IFRS4/MASB4<sup>70</sup> in the Malaysian context, it became, in our opinion, obvious that *qard* does not fulfil the requirements of a repayment mechanism according to article 18 of IFRS4 and MFSB4. That would render *takāful* technically a sort of insurance and not an alternative to insurance, implying the possibility of risk transfer.
- (iv) IFSB-18 tries to solve this dilemma by stating that the operator does not run an underwriting risk via the *qard*, but only a credit (counterparty) risk.<sup>71</sup> However, beside the fact that counterparty risk is also intrinsic to insurance (hence, all the solvency rules), time and amount of payment and repayment of *qard* are driven by underwriting parameters. And this is an insurance risk.
- (v) We should like to remark that para. 120 of IFSB-18 consider finite reinsurance (which excludes risk transfer by measurable mathematical parameters) as not being Sharī'ah-compliant. Since it is not the exclusion of risk transfer which renders it non-compliant, but rather wording issues and the absence of pooling, it might be worthwhile considering finite reinsurance as a model for sorts of reinsurance (among more than one cedant, possibly) that really stand up to a mathematical risk-sharing test, mirroring the known risk transfer tests of the conventional world. One just needed to take the definition of finite in IFSB-18, para. 27.iv.a: "In an arrangement of financial, or finite risk, *retakāful*, the relationship between the cedant and the RTU (*retakāful* undertaking) is effectively one of borrower and lender...". Is that not the idea of *qard*? One just needed, for example, to stipulate the same kind of arrangement involving more than one cedant at a time and enabling pooling and risk sharing would be there.<sup>72</sup>
- (vi) The question of opportunity costs for the *qard* (*ḥasan*) facility (or similar solutions) is not really touched on, as far as we can see.
- (vii) The segregation of funds (IFSB-18, para. 5) is also not a clear differentiating definition criterion of *takāful*. It is not really unique to Islamic insurance, and the conventional parallels are much wider than the Lloyd's syndicate mentioned in IFSB-18, fn. 4. The German Insurance Law, for example, does know the notion of "restricted assets" (*gebundenes Vermögen*) in every insurance portfolio. These restricted assets represent the insureds' rights, and the investment and use of the same is tightly limited by law. They are thus economically, albeit not juristically,

70 International Financial Reporting Standards / Malaysian Accounting Standards Board

71 GP 18, para. 20: "In a *retakāful* undertaking, the underwriting of the RRF needs to conform to the principle of mutuality; that is, the RRF belongs 14 to the cedant TUs, who share the risk between them, and not with the shareholders of the RTO. Correspondingly, the shareholders do not take on any underwriting risk (though they do assume credit risk, if *qard* is provided to the RRF but cannot be repaid). Management of the underwriting, investment and administration are performed by the RTO."

72 According to the findings in May 2016's panel discussion, the IFSB scholars' attitude towards finite reinsurance is particularly negative. This may make it worthwhile to conduct a workshop, with the aim of achieving a common understanding regarding pricing mechanisms between scholars and practitioners.

comparable to the participants' fund in a *takāful* setting. The statement of the earlier scholars that, in conventional insurance, the insurance premium became the property of the company "to proceed with it as it wishes"<sup>73</sup> has, according to our impression, not been made with a view to the regulatory situation of important Western countries.

### **Pricing and Marketing Issues**

While all this speaks in favour of a review of the axiom that *retakāful* is a risk-sharing mechanism, some experiences during the last decade provide hints that *qarḍ* may in fact be less crucial an issue than it appears. All except the Saudi cooperatives and the *mudārabah*-based companies (which are not to be found anymore – see IFSB-18, para. 17, fn. 10) have used the *qarḍ* concept for years now, and we see that in the general (re-)*takāful* business accumulated *qarḍ* is quite common. Nevertheless, A.M. Best (A.M. Best, 2016) stated that the shareholders seem to make profits on their shares while at the same time paying more and more *qarḍ*. One conclusion is that the *qarḍ* amounts are, to a large extent, calculatory rather than pagatory. *Wakālah* fees (or upfront-rebates on the contributions/commissions) deplete the RRFs and trigger *qarḍ*, which is paid from the same fee collected previously. The main result of this zero-sum game is the limitation of the probability of producing surpluses for the participants, since the repayment of accumulated *qarḍ* has priority. This kind of "artificial" *qarḍ* could not be taken as a measure for risk transfer.

Given all these interrelated issues, we conclude that, in order to solve the dilemmas, one needs to take on all those pricing-relevant elements (contributions, commission, *qarḍ*, surplus and profit commission) at one time, in an integral, technical and actuarial view, and this is what we are going to do in the following. From the marketing experience of a practitioner, these points are a serious obstacle to the development of *retakāful*, since the uncertainties in the systems and of the actual financial results, as well as an uncertainty concerning the remaining liabilities (for *qarḍ*), rendered potential clients insecure and made them prefer conventional reinsurance. And this is quite an interesting result – namely, that something that was supposed to be removed by the creation of *takāful*, uncertainty (*gharār*), would become one of its greatest disadvantages.

### **Ring-fencing and Diversification Effects**

Next to the law of large numbers, diversification of risks is the main basis for the economic value of insurance and even more for reinsurance. The requirement of transparency, and of managing the dilemmas originating in the hybrid set-up of risk funds and shareholders' funds, limits the calculatory use of this effect, as becomes evident in para. 102.f of IFSB-18, where a segregation of *qarḍ* facilities is required. We assume that a similar logic had already been

73 Abū Ġudda, p. 27: "Watakūnu 'aqsātu t-ta'mīni...milkan lil-šarikati, tatašarrafu bihā kamā tašā'".

discussed when introducing the risk-based capital (RBC) for *takāful* operators in Malaysia in 2011, but in the end the “holistic” view of both funds, of the *takāful* “company”, has prevailed. Otherwise, *takāful* would have gotten in a probably lethal competitive disadvantage vis-a-vis the conventional industry. Here lies another, potentially very dangerous, obstacle to the development of *retakāful*. The company view is what works economically and, without a holistic modelisation across the RRFs and the shareholders’ fund, the risk capital requirements may easily double or triple compared to the conventional competitors, who are already much stronger in many respects. The amount of this diversification effect can easily be seen in the risk report section of the conventional reinsurers’ annual reports.

Stressing this, the understanding of the method of modelling will be the basis for the pricing discussion in Chapter 3. It is our experience that many Sharī’ah scholars are not even aware of the modelling approach, and we deem the alignment of this method with the intentions of Sharī’ah to be a key task.

### ***Capital Management, Retrocession and Darūra***

IFSB-18 mentions this important element of the extension of the value chain with a view to the leakage of business into conventional reinsurance, but also with a view to the capital management of groups, including conventional groups, of which the *retakāful* operators are only units or windows. In fact, the economic difference between a stand-alone Islamic subsidiary of a conventional group and a branch or window does not need to be as clear as the juristic one, due to the fact that the *takāful* model allows cooperative companies to have shareholders. In the case of subsidiaries as well as windows, the backing capital (seed capital, *qarḍ* facility) stems from a conventional source and profits return to the conventional pool. And while IFSB-18 (para. 25) raises the concern that this capital may not have come from Sharī’ah-compliant sources,<sup>74</sup> there are scholars who simply state that even non-compliant money is automatically purified by being paid as *qarḍ* for a laudable cause.

In the end, capital relief and capital management is the most profound and irreplaceable value that reinsurance provides, and the approach of Sharī’ah scholars to this complex issue so far is in many cases to trust the management of the companies they supervise in their judgement on whether appropriate Sharī’ah-compliant capacity is available or whether *ḍarūra* requires resorting to conventional providers. Peter Casey explains the extraordinary difficulties of this judgement in the following very apt way:

*A standard issue in retakāful is the extent to which takāful undertakings have been given consent by their Sharī’ah advisers to place reinsurance with conventional reinsurers. It is extraordinarily difficult to understand where this is justified and*

<sup>74</sup> A concern also expressed in IFSB-11, para. 5, fn. 4.



*where it is not without looking at each transaction. It is relatively straightforward to say that there are specialist underwriting classes – space, for example – and some very large risks – perhaps the fleet of the national airline – for which the retakāful market lacks capacity and underwriting skills. It is also straightforward to say that there are many other types of business, typically personal lines, for which there seems to be no shortage of capacity. The questions that are unclear concern pricing and security. How far can lower cost, or a better-rated provider, be used to justify placing business with a conventional reinsurer rather than a retakāful undertaking? These are matters for Sharī'ah scholars, but the clear sense of IFSB-18 is that they should keep their fatāwa in such areas under close and frequent review.*

*Note that this is also an issue at the retrocession stage. There is little merit in ceding business to a retakāful operator if it promptly retrocedes the vast majority of it to a conventional firm, whether within its group or outside.*

These formulations show the challenge: one might suspect that managers use the complexity to overstretch the *ḍarūra* argument towards the Sharī'ah boards. On the other hand, *retakāful* solutions are complicated, each case is unique, and it would be a challenge to have Sharī'ah rules for measuring the necessity formulated. The suggestion by Peter Casey and IFSB-18 is probably the only way out: Sharī'ah boards shall make efforts to work themselves into the complicated cases individually, rather than limiting the economic leeway of the *takāful* operators by generic decisions.

Two thoughts can be added to the principles rightly mentioned in IFSB-18 regarding capital exchange between conventional and Islamic group members and the measures that have to be taken against fronting the Islamic business into the conventional group (para. 28.vi). The point is correct, but one has to see that the capital connection between the group members (effectuated in a compliant way via appropriated *wakālah* fees) is the justification for the inclusion of the Islamic subsidiary or window in the portfolio model, by which it enjoys essential diversification advantages and economy of scale.

The second point, which might be worth considering in further regulation, is the possibility of turning the internal contract relationship around; that is, rather than conventionalising its business by fitting it in the group portfolio, the Islamic subsidiary or window can try to render the overall group business more Sharī'ah-compliant, inducing, among other effects, an increase of Sharī'ah-compliant investments, thus creating compliant “pockets”. The same principle can be used for retrocession. To be feasible and acceptable for the conventional partners, of course, the compliant contracts need to be put in a language understandable by conventional colleagues (most notably the Arabic terms need to be explained, since they



usually have a bewildering effect on conventional stakeholders) and, as much as possible, free from unnecessary operational obstacles. That requires, to an extent, accepting the idea that *takaful* techniques are not so fundamentally alien that their essentials could not be expressed in conventional forms and terms. In that understanding, window techniques can be used in the opposite direction, as a chance rather than a risk, and that usage might be considered by regulators.

### ***Liability-based Investment Policies and Methods***

In an analogy to the segregation of risk capital, IFSB-18 prescribes an investment strategy that matches the assets and liabilities and assures the management of investment risk. That is important, and is perhaps not as problematic for the viability and marketability of *retakaful* as is the pricing and modelling of insurance risk. However, we suppose that a methodology still needs to be developed that takes account of the different levels of liability with the different parties (funds) that carry these liabilities. The system would be still more complicated than the conventional portfolio theories, since it should create a replacement for the conventional approach based on a risk-neutral position (that shall, by definition, not exist in Islamic finance), take account of the fact that most models and contracts comprise a *muḍārabah* relation on investment business, and make clear who is liable if investment losses have to be marked to market (a *qarḍ* being made via the insurance account?) or whether participants can participate in defining the investment strategy. That task is further rendered more complicated by the limited choice of *ribā*-free assets and the challenges of matching currency in international portfolios. IFSB-18 rightly points here to a potential threat to the resilience of *retakaful* business as a whole, and the creation of an actuarial working group to further devise risk management methods seems advisable.

## **Where all Dilemmas Meet: Modelling and Pricing**

The author, going through IFSB-18 has found references to the issues hindering *retakaful* development in various places, but mainly in Section VIII, “Special Issues”, including the important pricing parameters of commission and profit commission. Two important complexes are not really touched on by IFSB-18: the calculation of fees, and pricing guidelines in general. It is understandable that pricing usually is not part of standards and regulation. However, in this case, the dilemmas cannot be solved without having clarified the problems encountered in pricing of *retakaful* business.

### ***Imaginary Differences: The Continuum of Pricing Parameters***

As mentioned above, when working on the regulation and government of (re-) *takaful*, it is essential to have a clear and accepted definition of the terms “risk sharing” and “pooling”. Pooling in *retakaful*, according to the understanding of Bank Negara’s Takaful Operating Framework and the Malaysian Takaful Association, appears to be the levelling and cross-

purging of the results of different cedants in an RRF.<sup>75</sup> In view of the fact that the *takaful* operators are professional and profit-seeking entities, the economic value of this method is more than questionable as it involves moral risk and dilutes the reward of superior market strategies, leading to a serious anti-selection issue. Apart from this understanding of pooling being an expression of a more spiritual category – that is, of a solidarity mind-set – one might suspect that the industry was looking for a feature differentiating them from conventional reinsurance at all costs. But, choosing a feature that is not used by the conventional industry because it is economically disadvantageous would not make much sense.

Moreover, this attempt at self-differentiation is also in vain, since pooling happens in conventional reinsurance portfolios as well. It happens in the more common sense, because definitions of pooling in conventional insurance are hardly distinguishable from the self-definition of *takaful* – for example, “elimination of the uncertain risk of loss for the individual through the combination of a large number of similarly exposed individuals who each contribute to a common fund of premiums” (Manes, 1935). In *retakaful*, this is largely achieved through diversification. And it actually happens in the more specific way that a successful underwriter gives away – by taking reinsurance – part of potential surpluses, while a company that had accumulated bad risks can pass on part of the deficits arising from that.

Thus, in theory, the ideal Shari’ah-compliant solution, in the author’s opinion, was that each *takaful* operator carries the burden/advantage of its underwriting policy alone and shares the impact of random volatility with others. The problem is that one never knows for sure where the line between the two factors is to be drawn. In principle, it is the *retakaful* operator just as much as a conventional reinsurer who rates the quality of the portfolios entering its pool by simply pricing it. Usually that is done by setting the commission/profit commission in proportional treaties and by setting the premium rates in non-proportional agreements. *Such an individual pricing is explicitly allowed by the scholars.*<sup>76</sup> This is emphasised, since it is actually the first step from the purest pooling approach, where all participants contribute equally to carrying the overall losses of the pool. Once individual prices for different cedants who bring in the same kinds of risks (i.e. line of business) are accepted, the question of where to draw the line between random and systematic risks becomes a purely technical one and solidarity plays no actual role in the decision making. In negotiating and concluding the reinsurance/*retakaful* treaties, the cedants accept their quality “rating”

75 See Bank Negara Malaysia (2013), *Guidelines on Takaful Operational Framework*, 10.13: “In order to preserve the spirit of mutual assistance and joint ownership of the PRF, any form of performance-based payment to a cedant of a *retakaful* arrangement out of the *retakaful* PRF shall only be made based on the overall performance of the fund. In addition, any commission, profit-sharing or other performance-based payments arising from the *retakaful* arrangement shall be fairly redistributed to the relevant funds taking into consideration the source of the *retakaful* contributions and the performance of the funds leading to such payment.”

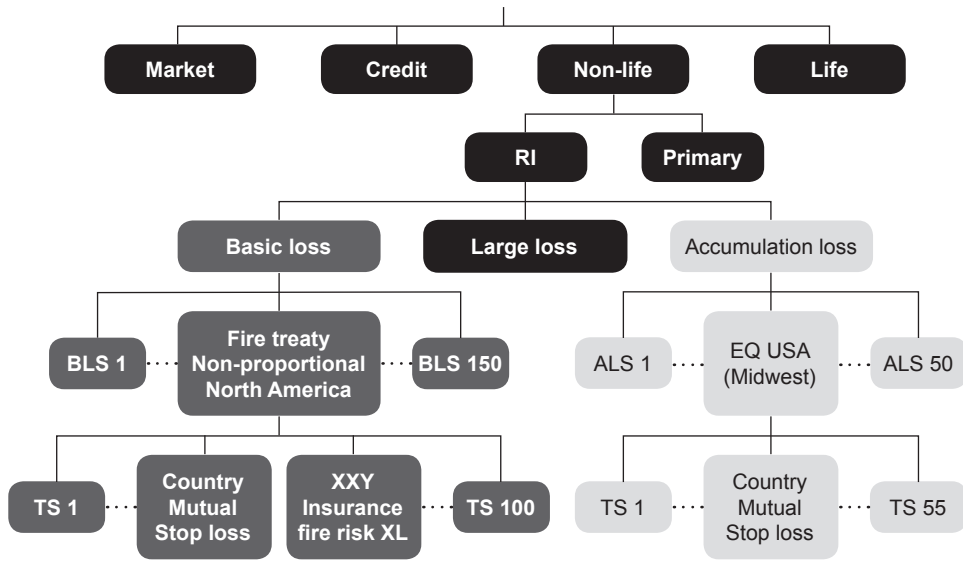
76 Mufti Hasan Kaleem during the Scholar meeting organised by the Swiss, Hanover and Munich Re’s *retakaful* operations in Dubai in 2011. On the same occasion, concerns regarding individual profit commissions were expressed, but individual pricing was accepted.

as fair; and while *takāful* operators accept giving away the remaining random surpluses (according to the Malaysian “pooling” approach), the conventional cedants accept paying a certain risk premium for being protected against negative volatility. The difference is rather that the (*takāful*) pooling approach works ex-post at the end of the underwriting year and the conventional reinsurance more by a pre-agreed contribution. That seems to be in line with the definition of the *Fiqh* Academy decision of 1985 regarding forbidden conventional insurance (“fixed periodical premium”). At a closer look, the line is not that clearly drawn, since the conventional cedants adjust their premium ex-post by profit commissions and losses carried forward, as well as via the mentioned multi-year compensation deals, whereas *takāful* operators can (and do) receive their profit commission by ex-ante rebates. This continuum of pricing parameters is now examined in detail.

### ***Modelling and Expected Value: How Pooling is done in Practice***

The rating (pricing) of, say, a simple fire portfolio is done by underwriting, which assesses historical claims experience (burning cost, pareto method), fire prevention measures, and exposure to earthquake and flood (by scientific models). The result is an expected value of claims in a certain period. The pooling (diversification) effect is measured on the level of a portfolio of such risks by modelling. Modelling takes place whereby the different classes of risks (market, operational, insurance risk, etc.) and, within the classes, the different forms, lines and regions are clustered and the correlation coefficients of the clusters are actuarially estimated. Since the coefficients are always between 1 and 0, the combined risk is lower than the sum of the individual parts, reflecting the diversification (pooling) effect. To take the simplest example: two perfectly negatively correlated risks (of the same size) will together require the same risk capital to reach a given probability of solvency as each of them would need alone (since negative correlation means that they cannot occur at the same time). Or, in other words: adding the second risk to the portfolio will not lead to additional risk capital requirements, and the average risk capital costs per risk will be halved. And that is the pooling effect that takes place in every (re-)insurance portfolio by mathematical rules, independently of whether an Islamic solidarity mind-set brought the risks together.

**Figure 5.1: Modelling Elements of a Portfolio from Risk Segments  
Down to Individual Treaties<sup>77</sup>**



A crucial and very basic method both for individual pricing and portfolio modelling, indispensable for actuarial practice, was mentioned in the above paragraph, namely: estimation/expectation. The Sharī'ah implication is equally important and needs to be clarified at this juncture. It is accepted by scholars that every economic activity is affected by uncertainty about the future outcome, the “small” or acceptable *gharār*. Every owner of a restaurant needs to estimate how much of each sort of dish will be ordered in the evening when he goes to the market in the morning. He may mitigate this risk – for example, by buying a large refrigerator – but he still needs to cope with uncertainty by using estimations. These “expectations” (*tawaqqu'āt*, in Arabic) are heuristic or formalised scientific, but in any event are based on rational methods, unlike foretelling (clairvoyance, in Arabic: *takahhunāt*). *Takahhunāt* are a sort of superstition and thus part of disbelief, while expectations are based on science and thus, we should say, part of belief. This draws the line between them. And from this point of view, it is logical that pricing based on (actuarial) expectations is allowed and necessary in (re-)takāful as well.<sup>78</sup> That point will be crucial for devising a harmonised *retakāful* solution, as we will try to do below.

<sup>77</sup> Figure 5.1 is taken from unpublished presentations of Ludwig Stiffl in 2010–11, based on Munich Re presentations of that time, corresponding to information freely available in the risk report of the annual report. Explanation of the acronyms: ALS: Accumulation Loss Segment; BLS: Basic Loss Segment; TS: Treaty Segment; EQ: Earthquake.

<sup>78</sup> Cf. the hadīth often quoted in relation to risk management: “*l'qilhā wa-tawakkal*. Tie your camel first and then rely on God.” Sunan At-Tirmidhi 2517.

**Figure 5.2: The Individual Risks are Aggregated, Incorporating their Dependency Structure Represented by a Matrix of (Estimated) Correlation Coefficients**

$$\begin{pmatrix} 1 & \rho_{1,2} & \rho_{1,3} & \rho_{1,4} & \rho_{1,5} \\ \rho_{2,1} & 1 & \rho_{2,3} & \rho_{2,4} & \rho_{2,5} \\ \rho_{3,1} & \rho_{3,2} & 1 & \rho_{3,4} & \rho_{3,5} \\ \rho_{4,1} & \rho_{4,2} & \rho_{5,3} & 1 & \rho_{4,5} \\ \rho_{5,1} & \rho_{5,2} & \rho_{5,3} & \rho_{5,4} & 1 \end{pmatrix}$$

**Starting Point: The Pricing Column and Its Takāful Interpretation**

In reinsurance pricing, the required premium is computed by the following approach:

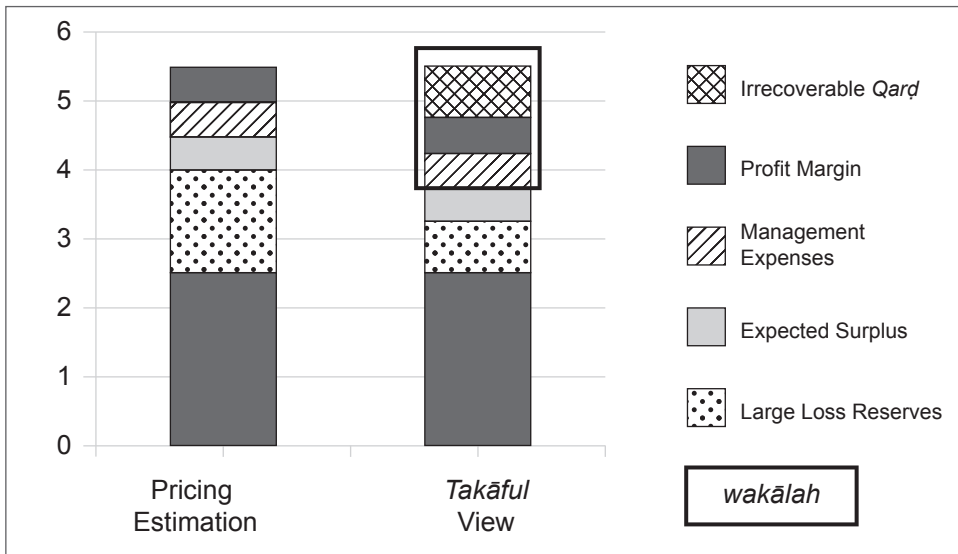
- The amounts required to cover the expected losses/risk premium (assessed by underwriting).
- A cost of capital loading for the volatility it brings into the portfolio. Which means this loading depends in principle not only on the characteristics of the risk itself but also on the composition of the existing portfolio to which it might have a homogenising or diversifying effect (see the correlation matrix in Figure 5.2).
- An expense ratio, which in a very complex organisation as a reinsurer depends on the system of distribution/allocation of overhead costs (for centres of competence, training, etc.) which is in use and for which no single ideal option exists.
- A surplus margin, in proportional business, which is likely to be refunded to the cedant (whether as individual profit commission or on a pool level).
- A profit margin.

Alternatively, the cost of capital and/or the profit margin can be built into the loss ratio, differentiated by volatility of the losses (basic, large and catastrophic losses) and the subsequent risk capital intensity of those risks.

In the Islamic insurance theory, the risk premium and the expected surpluses shall go to the participants' fund, from where they shall be used for claims, reserves or surplus refund, while cost and profit margin go to the shareholders' fund as a *wakālah* fee. At this juncture, we may again have a look at the question of risk sharing versus risk transfer with a view to possible deficits. As can be seen from Figure 5.3, and as trivial as it may seem, the premium collected has to be higher than the claims amount. This means that the conventional

reinsurer aims just as much as the *retakāful* operator at collecting the money for covering claims *from the insured*. He just backs the solvability by his capital, but he does not want to give it away for good, just like the *qarḍ* facility is supposed to function. Given that fact and the above-mentioned separation of “free” and “restricted” funds in German (Western) legislation, the comparability of the conventional and *retakāful* techniques is higher than it might seem and the discussion on risk sharing or risk transfer may actually miss the technical point. One might suspect that the *retakāful* operators are not doing risk transfer, but the reinsurers are definitely aiming at organising a risk sharing, in the sense that they use their capital but do not want to lose it. When looking at the figures as we are about to do now, the differences between the systems seem to gradually disappear.

**Figure 5.3: The Pricing Columns**



The only difference between the left column (conventional pricing) and the right column in Figure 5.3 is that, in the latter, the large loss reserve is split into a (*takāful*-compliant) large loss reserve, which remains in the RRF, and an “irrecoverable *qarḍ*” (see below) portion, which goes to the participants’ fund, building up another reserve there. The larger the irrecoverable *qarḍ* in the fee, the smaller the reserve, and vice versa; the sum stays the same as in the original pricing. With the building up of retained reserves in the RRF, the *wakālah* fee could be reduced over time and the degree of self-insurance of the fund would increase accordingly.

### **Irrecoverable Qarḍ**

The notion of irrecoverable *qarḍ* has existed since 2011 among practitioners (Stiftl, 2011; Papp, 2014) and can be regarded as the actuarial expression of the impairment of *qarḍ* that

is accepted by, for example, Malaysian regulation. It is a matter of clarity and transparency to consider in the pricing those parts of the deficits that are *expected* to be written off because there are no near surpluses *expected* to repay it. In that, there is no difference to conventional pricing. Now, as deduced above, the expected total *qarḍ* (and consequently, of course, the irrecoverable *qarḍ*) becomes smaller the higher are the accumulated reserves from earlier years in the RRF. Reserves from retained surplus, notably, reduce future *qarḍ* and, consequently, the *wakālah* fees, while increasing self-insurance. The balance sheet of the above-mentioned German mutual reinsurer consists by about 50% of free, accumulated equalisation reserves.<sup>79</sup> For a number of possible reasons (e.g. tight market conditions and lack of surpluses), we do not observe an accumulation of free reserves in the RRFs of the *retakāful* operators. This means that the dependency on the shareholders' funds capital is meant to persist for a long time and is not gradually being reduced.<sup>80</sup>

We thus state that the shareholders' fund of most *retakāful* operators is needed in the long run, and that its use for cushioning deficits is a frequent phenomenon, which has an impact on the profitability of its investment, since, for example, a larger part of it has been kept in cash and assets, matching the time horizon of the insurance liabilities. This, in turn, would make it appear realistic that the shareholders expect a return that also covers the cost of capital. At the moment, those costs are probably silently included in other pricing elements or neglected, since the opportunity costs of alternative investments are not very high anyway in the market conditions that have prevailed for the past years. But, that the establishing of a *qarḍ* facility requires the use of shareholders' capital, which is in turn priced internally with opportunity cost, appears to be economically logical.

What conclusion can we draw from this for the task of deriving pricing principles? We deem it is easier to handle if the *wakālah* fee is simply defined as what is left for the *retakāful* operator after risk charges and surplus reserves which go to the participants' fund. If risk capital charges are calculated separately, they will go into the shareholders' fund as part of the *wakālah* fee. If they are included in the risk charges, they will go to the participants' fund and cushion the shareholders' fund. For the shareholders, it is important only that a margin is charged to cover volatile (estimated) claims in the long run, so that their initial capital is not finally consumed. And this is, in our humble opinion, in line with the *takāful* theory. And this seems to us to be in line with the *takāful* theory.

79 See Figure 5.4 further below, where catastrophe and equalisation reserve constitute items 2 and 3 according to IFRS accounting systematic both in the left and right halves of the diagram.

80 This stance was confirmed by the comments of Peter Casey during the conference and its preparation, as well as by GP 18, para. 28.iv. Note that German law has an institution in its legislation on mutual insurers (VAG § 178) that resembles this. Although mutuals have no shareholders in German law, a young mutual can be supported by a "foundation fund" (*Gründungsstock*) of investors, which is, however, meant to be gradually repaid by accumulated reserves until this set-up investment is finally purged and only one – mutual – fund remains.

### **Profit Commission and Ex-post Pricing**

Stipulating individual profit commission (and sliding scale commissions) is tantamount to defining per-client (or even per-treaty) funds and, as mentioned above, this had been regarded critically by scholars and the Malaysian Takaful Association from a solidarity point of view – a fact that is also mentioned in IFSB-18. The author met the scholars at the pertinent meeting in 2011 and could not help mentioning that he found the argumentation in that point inconsistent, since it leads to loopholes. At the end of the day, profit commission is a method of ex-post pricing; and if individual pricing is allowed but profit commission is forbidden, the *retakāful* operators will (and do) grant the expected profit commission as a rebate ex ante – for example, as an increase of the *retakāful* commission or the risk charge. This is because a client with an expected surplus is a profitable client and can demand such advantages – also in the interests of the soundness of the RRF as a whole. In any event, whether deducted upfront or given as profit commission, the respective amounts are reducing the probability of paying surplus to the overall fund.

It may actually be possible that the position of the scholars has eventually also been triggered by an unfortunate use of technical terms originating in the Malaysian setting, and this is the “per-client fund”. As we have seen in the modelling section above, pooling (in the technical and mathematical sense of diversification, etc.) takes places whenever risks are collected in a portfolio, no matter whether the results are set off against each other directly or by mediation of the shareholders’ capital, whether it is calculated ex post or ex ante. Calculating an individual profit commission has nothing in common with building Chinese walls (as – in our humble opinion, wrongly – assumed by Abu Umar, 2015: 130), putting risks off the balance sheet, or any other measure that could effectively limit or prevent the pooling effect. We thus propose to eliminate, once and for all, the notion of “one client pool” as technically wrong and starkly misleading.<sup>81</sup>

There is another important mathematical aspect that should influence the *fiqh* decision on this matter. The scholars have already accepted many measures to prevent anti-selection and to assure a balance between fairness and solidarity: first, individual pricing as such, then *‘umūla* (risk selection incentives) and selection rebates. What is also allowed (in direct *takāful*, at least) is structured surplus redistribution, meaning that participants who individually caused deficits can be excluded from overall surplus even over a couple of years, until they have reached an individual balance (AAOIFI, FAS 13: 409). Since the ones who contributed to the overall surplus will receive more that way than by an equal distribution, it can be shown mathematically that eventually such a structured calculation comes down to the same financial effect as an individual profit commission with a loss carried forward clause. This holds mathematically true at least in years where an overall

81 The author dares to postulate this in the light of the fact that not only has he used this wrong notion before, but he may even have originated that usage.



surplus occurs and no deficit is outstanding. Should individual profit commissions be paid in a year of overall deficits, payments to “profitable” cedants are first still in the interests of the fund, in order to retain those who generate surplus. Second, those payments can be made from free reserves from former years in the RRF, or from the shareholders’ fund in following their duty and interest to keep the fund healthy. Accumulated ‘*umūla*, if there is any, could be used for it,<sup>82</sup> but also free shareholders’ money. The building and use of reserves should in any case be more common in *retakāful* than in direct *takāful*, due to the low-frequency, high-severity risks *retakāful* is taking on. One should even question whether the idea of calculating an annual surplus is advisable at all for the relatively small and volatile RRFs we usually find.

All these mathematical facts should be considered in a *fiqh* review of the issue of profit commission. And there is one more argument from inside *fiqh*: profit commission and sliding-scale commissions even have an advantage from a *fiqh* point of view, since the tangible ex-post calculation involves less pricing uncertainty than the estimated ex-ante calculation. More important is probably the practical advantage: profit commissions serve as risk selection incentives, just like the widespread ‘*umūla*. They are also very common in those frequent cases where the cedants view the quality of their book of risks as being much better than the reinsurer sees them. In those cases, profit commission is the preferred way to come to terms, leaving the final pricing adjustment to the actual outcome. Not being able to offer this way out of negotiation stalemates seriously limits the competitiveness of *retakāful*. And this sacrifice is made without, as we tried to show, a convincing technical justification.

## ***Retakāful* Commission**

### ***Who Deserves to Receive Retakāful Commission?***

The issue has been identified already some time ago. Reinsurance commission in the international practice serves as a refund of the direct acquisition costs incurred for the ceded parts of the insurer’s portfolio and as support to carry his general expenses as far as he has incurred it (Stiftl, 2011; Abu Umar, 2015: 136.f), since the reinsurer, being a sort of wholesale operation, generally incurs lower costs per unit. At least in the second function, the commission should by right go – at least one could argue – to the shareholders’ fund from where expenses are paid. In practice, it goes to the *takāful* operator’s participants’ fund first and from there, as part of the *wakālah* fee, to the shareholders.<sup>83</sup> This would make no

82 It is well understood that ‘*umūla* is usually meant by the scholars as an incentive for the work involved in risk selection, not as a financial tool to avoid anti-selection. But that, again, is a notion that could be challenged, since we are quite sure that ‘*umūla* is needed for financial needs – namely, for cushioning downsides. Besides, the *retakāful* operators may be free to use their money for the benefit of the RRF.

83 It has been reported during the panel discussion on this article by Mr. Jaffer that, at least in family *retakāful*,

difference, if the fee, as well as the reinsurance commission, closely reflected the costs. But this is usually not the case, which leads to financial distortions (analysed in Stiffl, 2011) and to a lack of transparency and complications which add to the operational obstacles to *retakāful* marketing. During the correspondence on this chapter, Peter Casey somehow took the opposite stance, saying:

*The question that needs to be asked is how paying a premium  $P$  and receiving by a commission  $C$  differs from simply paying the net premium  $P-C$ . The first answer is that if a *retakāful* premium is paid from contributors' funds in the risk pool, as it normally will be, and if the commission is not paid back into the same pool, then there will be a net transfer from contributors' funds to shareholders' funds, in excess of that contractually agreed. The manager will have an incentive to buy more *retakāful* capacity than is optimal, to benefit from the commission.*

This argument, although we do not simply accept it, opens the view to a number of important and underestimated issues:

- (i) It highlights the fact that reinsurance commission, at least in the markets where *takāful* operators are usually active, is of extreme economic importance to the companies. Quite often, it is their largest single income stream – a fact that, of course, has an enormous impact on their buying decisions.
- (ii) This importance is further increased by a gearing effect – that is, an excess of commission paid over the costs that have in reality occurred in acquiring and producing the ceded business. This effect would, in fact, generally lead to a tendency for more (proportional) reinsurance to be bought, up to the degree where in some cases the retained premium is lower than the reinsurance commission received and the (conventional) insurer ceases to be a risk taker and instead becomes an intermediary for the reinsurance market.
- (iii) However, taking the perspective of *takāful* operators and *retakāful* operators who shall segregate the operational and risk part of their business, this gearing effect does not mean that the payments in excess of the expenses are financed from risk business, reserves or reduced profits/surpluses. As mentioned above, the reinsurer has an advantage from economy of scale, an operational effect that can be shared with the cedant and does not necessarily have to go to the participants' fund. At the end, one could also argue that skillful negotiation with the reinsurers is a valuable operational service of the *retakāful* operator to the participants' risk fund, from which it is allowed to benefit.

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there were *takāful* operators who preferred conventional reinsurance because they could choose to channel the reinsurance commission into the shareholders' fund. We did not hear of that before, nor are we in a position to judge or verify this comment.

- (iv) Casey's remark, that a channelling of the gearing effect or parts of it to the shareholders' fund would be a payment over and above the contractually agreed payments, is, of course, correct. But this is only the state of things in current *retakāful* treaties, which can be changed. It would, in the author's opinion, not only be possible and legitimate to stipulate a ratio of splitting incoming commission between the participants' risk fund and the shareholders' fund (see Stiftl, 2011); but would also add to the clarity of the *retakāful* offering if the economic importance and the technical background of this issue were acknowledged and its handling discussed under the Sharī'ah pretext.

But, while, in theory, the hearing effect can be defined and explained, in practice, it will rather be estimated, just like the diversification effects in the course of the risk modelling explained above. At the end of the day, reinsurance commissions are, in practice, not merely calculated but also negotiated, and they are a factor that is to some extent disconnecting the reinsurers' and insurers' pricing basis in proportional business. If the *retakāful* operator who conducts the negotiation does not directly benefit, the agency dilemma may come up again. If he benefits, it also comes up, just from another angle, as Casey has shown. Whether this effect actually leads to higher reinsurance commission than in conventional business (and thus to a depletion of the RRF) can only be shown by conducting a survey on an industry level.

### **Possible Justifications of Net Retakāful Contributions**

Let us close the discussion of this important issue with some remarks on the directly related matter of net *retakāful* contribution. When *retakāful* appeared on the market, conventional reinsurers often noticed the stipulating of a net contribution instead of explicit mentioning of commission ratios as the main, even the only apparent, difference from conventional reinsurance treaties. And, from a conventional view, this was also perceived as a rather superficial attempt at self-differentiation without any substantial reason, since one could argue that the manner of calculation would not change the financial impact. In fact, we find it conceivable that the practice originates in a misunderstanding. We think it originally came from the AAOIFI directive that *takāful* operators should not accept commissions from conventional reinsurers because they might stem from unlawful sources. And while this was applied to the treaties *takāful* operators concluded with conventional reinsurers during the time when there were very few and small *retakāful* operators, the practice simply continued when *retakāful* treaties became more common, although the said AAOIFI directive does not apply to *retakāful* operators. Peter Casey, on the other hand, gave another justification: "... even if the commission is paid into the same pool, accounting conventions may allow it to be recognised immediately as income, while the premium does not have to be recognised immediately as an expense; this may distort financial reporting." It is a valuable hint to investigate under which legislations such distortions can occur.

### **Risk Rates (Non-proportional)**

This point serves as a paradigm of the pricing challenges in general, particularly when large and volatile treaties or facultative risks are concerned. First, a non-proportional pricing column does not comprise a margin for surpluses; and second, the large losses occur rarely, but with high severity, which means they would destroy the surpluses of the more stable mass risk portfolios (such as motor business) for years. Based on that logic, contributions from such risks shall be earmarked as equalisation reserves, and may even be kept in separate funds; in any event, they will be excluded from surplus redistribution on the mass business. This differential treatment already contains some sort of acknowledgement that *retakāful* business does not fit perfectly into the cooperative theory of *takāful*. But still, those reserves are the property of the participants and must be distributed in the case of winding-up, while possible deficits at the occurrence of large claims will be paid by the shareholders' fund as *qarḍ*. It thus appears that the expected value of these non-proportional sub-funds over the whole period of operation is negative, since there can be a negative balance (irrecoverable *qarḍ*) for the shareholders at the time of winding-up, but possible positive end-balances will be transferred to the participants. That leaves for the shareholders a maximum amount of zero, but with a downside risk. It is for this reason that some scholars have allowed the appropriation of these reserves by the shareholders, but only in the case of winding-up, to allow the overall expected value of the transfers to be zero. This expected-value perspective is, in our opinion, one possible way to solve the actuarial dilemma of non-proportional *retakāful* and to maintain the system and transparency of the fund segregation and the *wakālah* system, and we suggest that it be considered by interdisciplinary working groups of the standard-setting organisations. The options and issues which we feel need to be discussed in such working groups are:

**Table 5.4: Overview and Comparison of Pricing Methods and Approaches**

<i>Takāful</i>	Conventional
Factual modelling?	Modelling
Ex-post sharing	Ex-ante pricing (but also compensation, etc.)
Commission (to the participants' fund for <i>wakālah</i> fee)	Commission (to cover expenses)

## The Standardisation Proposal: Cutting Through the Gordian Knot

### **Contract Certainty by Simply Switching from Retro- to Prospective Calculation**

We shall start by reminding the reader of the fact that we are still speaking about the “usual” *retakāful* on an open fund basis where every market player can join and leave, provided he can agree with the *retakāful* operator on a price, without knowing who else is participating in the RRF. This is the most challenging scenario, and it will probably stay the decisive one in terms of further development. Nevertheless, the alternative pool approaches mentioned above deserve, in our opinion, more attention and development than they currently enjoy.

As deduced from the pricing column above, the participants do in any event pay a solidarity contribution to the fund, which is built into the contribution as an expected value. It is a solidarity contribution in the sense that it is forfeited – quite in line with the *tabarru'* concept – to cover losses of anyone in the portfolio,<sup>84</sup> although at the same time it is rated to be an equivalent of the risk (the expected claims) the cedant brings into the pool. Since nearly all treaties in reinsurance are of an annual duration and are reviewed at the renewal, improved or claims-stricken portfolios are repriced accordingly on an annual basis. This means that, under the condition that the relationship is ongoing, the results are smoothed over the years and both negotiating parties keep an account of the mid-term performance and automatically make it a basis of renewal negotiations – be it in *retakāful* or in conventional reinsurance. It is just that the smoothing does not take place at the end of the financial year by surplus redistribution or – theoretically – by injections. Instead, it takes place at the beginning of the year in the form of a rebate or a price increase. This simple switch from a 31 December perspective to a 1 January one ensures that the contributions are flexible and there is still contract certainty in the sense defined above. Even profit commission and sliding scale commissions are viable in this way, because they depend only on the portfolio of the cedant, which he knows, of course, better than anyone else, and not on the composition of the total RRF, which the cedant could never gauge. This view, in our opinion, leads to the only sound and viable way to develop *retakāful* portfolios.

Sure, all that takes place on a bilateral basis, and the bilaterally agreed contributions sum up to build the RRF of that particular year. And the scholars tend to see a bilateral perspective as the basis for unacceptable *gharār*. But, first, we don't see why the same operation is acceptable when regarded at an accumulated level but is unacceptable at the individual level. Can the sum of unacceptable practices be acceptable? And second, as we have seen, this technique is *tawaqqu'*, not *takahhun*; it is based on scientific methods the inherent uncertainties and errors of which are, moreover, corrected on a yearly basis. It

<sup>84</sup> We came across practical examples of *takāful* operators who tried to get back all the surpluses of a year, or even of a single treaty, which is both an exaggeration of the profit commission idea and an example of opportunistic behaviour.

may be that when the majority of scholars decided against the permissibility of conventional insurance “based on a fixed premium”, they did not have the full picture of all the techniques and methods used. There is, in any case, no mention of how they viewed conventional insurance with a surplus redistribution. At the same time, the minority around Mustafa az-Zarqā or Monzer Kahf, who argued against a total prohibition (*tahrim*) on the basis of the use of large numbers (and, by the way, prevented the *ijmā*), were closer to the technical reality. Should the view prevail, nevertheless, that only a retrospective (and directly pooled) surplus redistribution can render *retakāful* legitimate, we should need to ask how this can be defined against the permission of individual and prospective pricing.

The experience of the Malaysian “pooling” approach provides proof in favour of – rather than against – the above, since apparently it could only be established among the Malaysian operators, who know each other. It is in that sense closer to a “closed” than an “open” pool, and is apparently reserved for the less volatile lines of business (life). And even that may have taken place in view of the serious wishes of the regulator. According to our experience, the growth of open *retakāful* pools can only succeed by maintaining the contract certainty, as explained above, which may involve a rather conventional appearance and the factual exclusion of direct cross-pool surplus redistribution. Cross-pool surplus may occur as a non-contractual benefit, such as a windfall, but given the tight market conditions, no cedant should – literally – count on that. Finally, we should remark that it is not the immediate economic interest of the *retakāful* operator that drives the treaties towards individual, bilateral surplus calculation. For the *retakāful* operator, it would make no financial difference if they paid the “expected surpluses” of their pricing basis to all cedants as a surplus instead of individually as a profit commission. It is usually the wish of the cedants and the subsequent danger of anti-selection in the pool that creates this operational necessity.

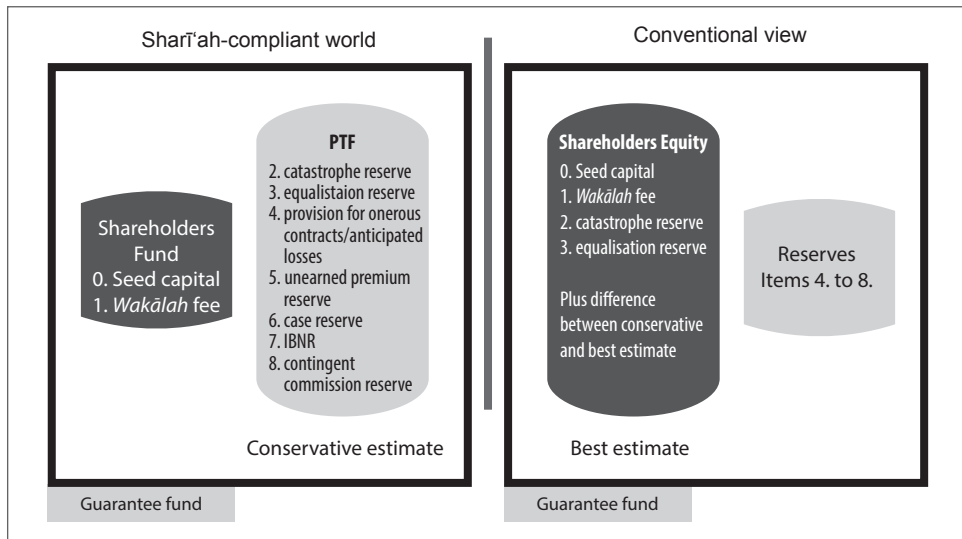
### **Levels of Direct Cross-subvention**

In order to avoid terminological confusion, we stress again that we use, in line with international insurance science, the word “pooling” for the mathematical effect described above, which builds the basis or the economic functioning of insurance in general. This meaning of “pooling” differs from that often found in Islamic writings, such as the Malaysian *takāful* operator framework, and, consequently, a different name is required. We suggest using, for the time being, a sort of descriptive name: “direct cross-subvention (or off-setting) of surpluses and deficits”. If we adopt the prospective pricing as a viable perspective, what remains to be maintained from a compliance point of view is transparency. Derived from the pricing methodology, there would be different forms of financial means in the RRF:

- (i) Contributions from non-proportional risks, earmarked for the shareholders, but only in the case of winding-up and only after all contractual rights of the cedants (and possibly other stakeholders) are satisfied.

- (ii) Reserves for unexpired proportional risks, known claims (case reserves) and claims incurred but not reported (IBNR).
- (iii) Reserves for premium refund (or profit commission to individual cedants, including loss carried forward).
- (iv) Accumulated free reserves/retained earnings (catastrophe and equalisation reserve) against which no direct rights of named clients stand. These could be redistributed to the cedants on a fund (portfolio) basis when no *qarḍ* is outstanding. But it is not advisable to let the cedants expect such payments on an annual basis, at least not in general *retakāful* business. Moreover, the more such reserves are retained, the stronger will become the self-insurance effect (risk sharing).
- (v) Against this, *qarḍ* has to be calculated in the manner of a conventional deficit account or loss carried forward across the portfolio.

**Figure 5.4: The Impact of the Pricing Reserves (for Irrecoverable *qarḍ*) from a Balance Sheet and Reserving Point of View**



The main idea of Figure 5.4 is the visualisation of different ways of applying international financial reporting standards' items. The difference between conventional and *takāful* in that view is only in whether the reserves under items 2 and 3 (catastrophe and equalisation reserve) are held in the RRF or in the shareholders' equity. If these respective reserves of (re-)*takāful* undertakings are not built up in the RRF, but kept as a *qarḍ* facility in the shareholders', the difference becomes even smaller.

From this accounting perspective, definitions of mutual, cooperative and stock-capital based reinsurance can be derived as follows:

- Mutuals do not have shareholders and thus do not have stock capital. But when taking larger risks, they have to make more use of retrocession and reduce their equalisation reserves accordingly, as we saw in the case of Kieler Rück.
- Hybrids (usual *takāful* undertakings and possibly *retakāful*) have shareholders' funds, but tend to build up the equalisation reserves in the participants' (or *retakāful*) risk funds.
- Stock companies (the usual conventional/commercial companies) hold the equalisation reserves in the shareholders' fund. Their business is risk carrying.

We should propose for terminological clarity in reinsurance that mutuals and hybrids together can be called "cooperative reinsurers", while hybrids and stock companies together can be subsumed under "stock-capital based reinsurers".

Obviously, these are differences in the ideal view that should not blind us to the basic fact that the three forms have in common: in the end, they all need to raise capital in order to cover large risks. This capital can come from shareholders, participants or reinsurers/retrocessionaires, and it is available at different economic costs and with different conditions. Therefore, in particular, hybrids and stock-capital based reinsurers tend to use all three sources at the economically optimal available mix and can thus phenotypically become very similar to each other.

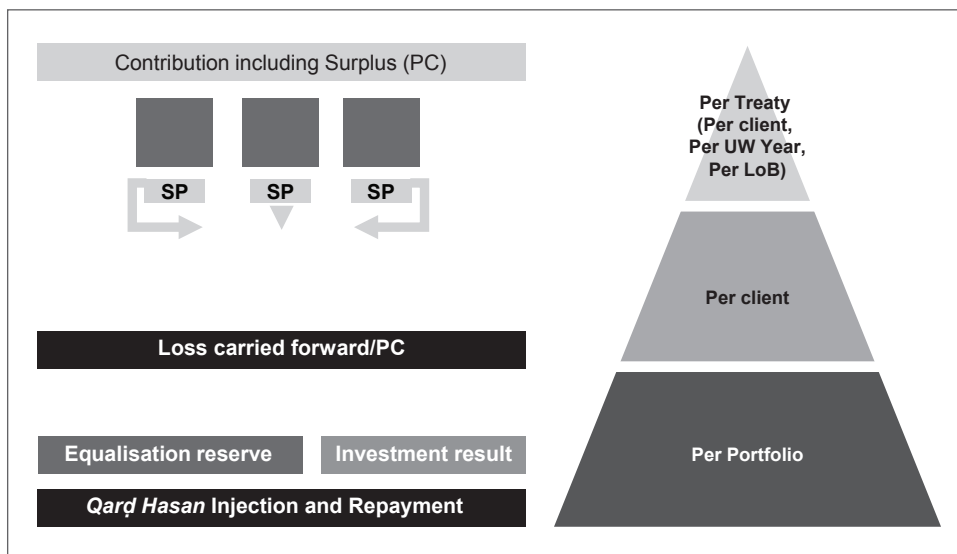
In this accounting view, one is able to rather easily define from the annual reports whether a specific company behaves more as a cooperative (containing, or in other words: sharing, the large risk in the participants' fund) or stock-capital like (carrying these risks to the shareholders, or in other words: transferring risk to them). Even mutuals can transfer the risk – namely, to the retrocessionaire, as we have seen in the initial example from Germany.

### ***Balancing Solidarity and Risk Selection***

Figure 5.5 is one proposal to balance fairness and risk-selection incentives against joint risk carrying, while remaining transparent. In summary, the cedants shall not expect any surplus or injections above that which can be estimated knowing only their own treaty and portfolio. To repeat, this is a solution for an open-fund *retakāful* portfolio. If the cedants know each other and participate in joint decision making, they could adjust this – for example, in setting investment policies or accumulating equalisation reserves from their surpluses.



**Figure 5.5: The Layered Pyramid: Addressing Issues of Justice and Anti-selection with Differentiated Responsibilities<sup>85</sup>**



### **Wakālah Fee**

The *wakālah* fee is supposed to be the central pricing parameter of the model of the same name and scholars stress that it is crucial for the transparency (and thus legitimacy) of the system to publish the fee to the public and to the participants. Before going into detail about how to determine the fee, we should like to express our doubts about the importance of doing this altogether. The experiences of the past decade have to some extent shown – quite to our disappointment – that the fee is of secondary importance to the *retakāful* operator and of nearly no importance to the cedant. Let us scrutinise why that is so, with a view to a pure *wakālah* model or the common hybrid model:<sup>86</sup>

- (i) The *wakālah* fee determines which part of the original contribution goes to the shareholders' fund, while the rest going to the RRF. We suggest that the fee is relatively unimportant because it does not stay like that in a business environment where *qarḍ* is quite common. As we saw, economically, *qarḍ* is not a loan (not in an open pool, at least), but a loss, whether it is considered as such from the beginning or impaired after a few years, like a loss carried forward. For the *retakāful* operator to be profitable in the long run, the fee must thus include the irrecoverable *qarḍ* in one way or another. The *retakāful* operator takes the fee to use it for paying the *qarḍ* later on.

<sup>85</sup> Explanation of acronyms: PC: Profit commission. SP: Surplus. UW: Underwriting. LoB: Line of Business

<sup>86</sup> We consider for the moment only risk business and leave aside *mudārabah* shares on the investment. Systems where the operators' income comes mainly from investment would deserve their own actuarial analysis.

- (ii) If that is not done, there is even less transparency. Since the *wakālah* fee limits the upside of the *retakāful* operator, but the downside by (irrecoverable) *qarḍ* is unlimited, there is a tendency to overbid in the fee, not so much from an intention on the part of the *retakāful* operator to exploit the cedants, but to avoid their bleeding out.
- (iii) A high *wakālah* fee, again, is depleting the RRF and consequently increasing the probability of a deficit in the RRF, which subsequently has to be covered by *qarḍ* (the phenomenon we called “artificial *qarḍ*” above). For the *retakāful* operator (and *takāful* operator), it is a zero-sum game, except that the probability of paying distributing surplus in very good years is minimised. And, given the margins one can observe in the markets, this is again not from any intention on the part of the *retakāful* operator to exploit anyone, but because, on average, the operators cannot afford to let the surpluses go out of the shareholders’ fund–RRF system.
- (iv) The latter point is the central perspective: shareholders’ fund and RRF (called the “company” level in Malaysia) constitute together the guarantee fund for the insurance mechanism, and the *wakālah* fee levels (with subsequent *qarḍ*) only determine a (temporary) shift between the two funds. Economically decisive are the in- and outflows at the company level. These are loss ratios (expressing price levels, including profit commission<sup>87</sup> and claims frequency) and expense ratios, including acquisition costs – that is, what is paid to the insured, providers and employees. Together, they form the combined ratio of the business or business segment. If the combined ratio is in the long run at 95%, it means that 5% of the gross figures can be distributed between the shareholders and the participants. A.M. Best recently did a survey of direct *takāful* companies in the Middle East (A.M. Best, 2016) which showed that profits of the shareholders rose together with the outstanding *qarḍ* amounts. We suppose this proves that the *wakālah* fee and *qarḍ* are calculatory and not pagatory figures, purged against each other. In other words: The *takāful*-specific terms that are discussed in all that breadth (and often confuse and deter possible cedants and investors) do not seem to express the economic reality.
- (v) The mentioned real performance figures, however, are disclosed in all annual reports of (re)*takāful* companies and conventional insurers alike. To publish in addition a pre-set *wakālah* fee does not really add transparency. And it has no impact on the individual client and hardly any on the fund. The impact of a *wakālah* fee level on that distribution of a long-term margin between shareholders and participants is rather indirect and complicated. A *muḍārabah* – or, more appropriately, *mushārakah*<sup>88</sup> – share would be more transparent. The Saudi Ta’āwuni system can actually be described as such a *mushārakah*.

87 As said above, the individual profit commission is a pricing parameter that is determined by the outcome and by the expense ratio defined in the PC statement of the treaty. This latter ratio, usually about 10%, would be comparable to a *wakālah* fee as it is supposed to work in theory.

88 More appropriate because, since a *muḍārib* does not take liability with his capital, but with the *qarḍ hasan* obligation, this is quite the case.

Hence, in order to achieve harmonisation, it is urgently suggested that the IFSB, the AAOIFI and regulators organise workshops between scholars and actuaries with the aim of analysing the business from that technical perspective and then drawing conclusions. But, given that a revolutionary proposal such as a *mushārah* or *mushārah ta'āwuniya* (Muhammad, 2010) will not be accepted in the very near future, how can the *wakālah* fee be determined in the meantime? On the direct *takāful* level, the International Islamic Fiqh Academy (IIFA, 2013) has suggested mandating independent bodies or even regulators with determining the fee. The author has serious reservations about this suggestion, from a competition and efficiency point of view, as it could finally end all investments in *retakāful*. But while this idea is worth discussing for direct business, *retakāful* is, in our opinion, much too complex, diverse and volatile to achieve clarity on the cost and margins by outsiders. In addition, as shown at the beginning, the efficiency and value of *retakāful* depends on diversification effects (also diversification effects between *retakāful* funds and the conventional portfolios of operators who belong, as a window, branch or stand-alone company, to conventional groups) These diversification effects are based on internal estimations, and the company doing the estimation confirms its trust in it by allocating its capital accordingly. Giving that right of estimation to outsiders who have no “skin in the game” will seriously change the balance of interest.

### **Operational Obstacles and a Simple Supervisory Approach**

In principle, a *retakāful* operator should possess a pricing system that internally allocates the direct and overhead expenses, as well as the expected margin, to a certain piece of business. If the RRF does not carry expenses except claims and claims-related ones, the *wakālah* fee can also be defined as 1 minus the loss ratio. But we now think that a calculation of fees in that granularity per client and treaty is not necessary, in particular, as it (a) makes cross-subsidisation of more-or-less profitable business segments impossible and thus further hinders operative success; and (b), as we saw, the individual *wakālah* fee does not have a direct impact on the client and thus it does not hurt him and his legitimate interests if the exact calculation of the fee is done on an accumulated basis. But, there is another operational obstacle in reinsurance, and even more in *retakāful* where the portfolios are rather small and abruptly changing at each renewal period: even the accumulated calculation can only be done on the basis of the known portfolio – that is, after the treaty renewal, and not when negotiating the treaties. Given that fact, the *wakālah* fee written in the treaty would, like the premium rate itself, be an ex-ante estimation that can be adjusted at the next renewal to make good for possible deficiencies in the year before.

It is definitely true that mass business, like solvency-induced quota share treaties, creates lower costs per unit and implies lower volatility, than non-proportional and facultative business, where expense ratios alone can reach rather high figures. But apart from this common knowledge, we state that the widespread practice of setting *wakālah* fees at a given,

even-numbered level such as 20%, 30%, or even at maximal levels that can be undercut in practice, may not be inappropriate compared to the – principally possible – calculation of, say 23.45%, for an individual treaty. One should not think that disclosing a *wakālah* fee in the *retakāful* treaty is the main and sufficient guarantee for avoiding *gharār*. To follow the original intention (*maqṣad*) of creating a cooperative system and avoiding exploitation of the cedants, it is much more helpful to monitor the figures from the annual reports: the real expense and loss ratios, the building up of free reserves (i.e. self-insurance) in the RRF and – above all – the profit margins of the shareholders. That is, where exploitation, if at all, happens. Reinsurance is too complicated to monitor the intentions on the micro-level; the variety of business lines, periods and estimations will always distort the picture. But by observing the overall results and, in particular, the margins earned, it is possible.

## Conclusion

*Retakāful* in general, we dare say, is not flourishing, although a clear need for its creation was expressed and answered a decade ago. One reason is a leakage to conventional reinsurance, which comes at least partly from a number of dilemmas in the *retakāful* proposition. The efforts of the IFSB and others to create harmonisation and clarity of the business model have thus set the right priority. The dilemmas of *retakāful*, in turn, originate from its different and concurring aims: being Sharī'ah-compliant but competing on the world market, being cooperative and commercial, being risk sharing in a market where risk transfer is the required good. The persistent need of capital support from the shareholders has been identified as the “fundamental challenge”.<sup>89</sup>

IFSB-18 goes deeply into detail about the elements of this conundrum. But still, the objective of IFSB-18 was specifically to highlight key regulatory issues facing the *retakāful* sector. Technical issues were not its main focus. Second, it tries to solve the conundrum within the given framework of the operational model – namely, *wakālah*. What we have tried to do in this chapter is to identify more what we feel is missing from IFSB-18 than to comment on the points that are present. First, we think that this is helpful in widening the view from a (Sharī'ah-) juristically defined model to the economic environment and situation in which *retakāful* is working, including by taking a look at existing cooperative systems. Using and creating closed pools and syndicates, as well as mutual carriers, can play more to *retakāful*'s strengths than competing with the big players in the open market. And second, the set-up is finally to be defined from the technical side at least as much as from the legal one.

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89 Peter Casey pointed this out in his comments. See also his comments in the appendix to this chapter

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## APPENDIX 5A: CHALLENGES IN DEVELOPING THE *RETAKĀFUL* SECTOR (A Commentary to Chapter 5)

### Peter Casey

#### Introduction

Both before and after the conference, Dr. Stiffl and I have had several rounds of discussion on some of the issues he raises and he has reflected – and, indeed, quoted – my views at a number of points. There remain, however, a few comments which I should like to offer.

#### Business Structures

Reinsurance, as Dr. Stiffl indicates, is concerned very largely with reducing the overall volatility of a pool of business. It is intended to deal with extreme outcomes, and therefore needs substantial capital from the outset. This would be a commercial necessity even if it were not a regulatory one. Furthermore, the best way to reduce the volatility of the pool as a whole, and hence the amount of capital required, is for it to accept uncorrelated risks. This, however, means that the insurers ceding those risks will have little by way of common interest; they will not form an affinity group in any meaningful way. It is therefore essentially impossible for a purely mutual reinsurer to be created now, outside a few very special situations, and in those situations it is likely to be substantially dependent on retrocession, which merely moves the problem one step up the chain.

Hence the pure mutual model for *retakāful* is not commercially available, and we are forced to adopt some version of the current hybrid model in which not only does a shareholder company manage one or more pools of funds on behalf of contributors, but the shareholders must from the beginning put up substantial capital. Unless the shareholders are extraordinarily philanthropic, they will expect to earn a return on this. Furthermore, the capital will be needed for a long time. In direct *takāful*, it is at least possible to aspire to a point where accumulated surpluses have removed the need for substantial shareholder capital, and the operator is indeed managing a mutual pool on behalf of contributors. The capital-intensive nature of *retakāful* makes this aspiration a remote one in terms of time. The shareholder capital will need to be there, supporting the risks, probably for decades.

These are, I believe, points on which Dr. Stiffl and I agree, and we are both concerned with the question of how that capital can earn a fair return, consistent with the essential principles of *takāful*, and preferably without creating any perverse incentives.

## Pooling

The concept of risk sharing is integral to both *takāful* and *retakāful*. For this to happen, the risks and contributions from multiple cedants must be pooled, with the pool belonging to those cedants. A pool of one, or a distribution of surplus based on the performance of an individual cedant's risks, appears to me very difficult to reconcile with the relevant Sharī'ah rulings.<sup>90</sup>

## The Issue of Pricing

One element of earning a fair return is charging a price that properly reflects the risks involved. In this context, the word "price" is a tricky one. The cash flows between a *takāful* undertaking and a *retakāful* undertaking may include not only premiums and any claims payments, but various other payments often referred to as "commissions" even though the term may be a little misleading. In *takāful*, unlike conventional insurance, there is also the question of the funds within the undertaking from which payments come and to which they go. There is also the difficult issue of ex-ante and ex-post pricing. These are the issues on which Dr. Stiffl concentrates.

It is common ground that in *takāful* a premium can be set on the basis of the individual risk involved; this is acknowledged explicitly in the IIFA resolutions already cited. There is also, I think, no doubt that this may be based on past experience in the sense that if, for example, my claims record suggests that I am a bad driver, a *takāful* undertaking can legitimately charge me a higher premium. This is an ex-ante premium if it is the price for the next year's cover, and is one I am free to reject, by taking my business elsewhere.

In the world of *retakāful*, as in reinsurance, the ex-ante price may be expressed as a premium offset by a commission, often called a "ceding commission". I can see no good reason for this. The reason often cited, that the *takāful* operator bears a greater share of business acquisition and other administrative costs than the *retakāful* operator, is true but irrelevant. The *takāful operator* is likely to have been remunerated for these already, through a *wakālah* or other fee. On the other hand, there are dangers. One is that a ceding commission may be paid into a different fund in the *takāful* undertaking than that from which the premium comes, acting as an additional transfer from policyholders to shareholders. Another, related, one is that it may create an incentive to take out more protection than is in the best interests of policyholders. I therefore much prefer a single, net premium.

90 Most notably the International Islamic Fiqh Academy (IIFA) resolutions of November 2013, which incorporate as appropriate earlier IIFA resolutions on the subject.

On the other hand, I see no objection to Dr. Stiffl's very interesting suggestion that the *wakālah* fee might be set individually for each *retakāful* contract, reflecting in part the risks to which it indirectly exposes the shareholders' fund of the *retakāful* undertaking.

There seem to me greater problems with ex-post pricing – that is, adjusting the effective price paid for the period's cover in the light of the actual experience in that period. This will typically be done through something called a “profit commission”, but there are other possibilities. What is being referred to here is not the sharing of a surplus generated by the overall experience of multiple cedants; it is a commission or rebate based on the experience of a single cedant's business. Commercially this is attractive, especially for treaty business where the actual risks are not known in advance, because it gives the cedant an incentive to maintain high underwriting standards, but I find it hard to see how it can be reconciled with the principle of risk sharing.

I note that Dr. Stiffl believes that some scholars are indeed willing to approve forms of ex-post pricing. If this is so, it would be very helpful for their reasoning to be available publicly.

## The Fundamental Challenge

The fundamental issue remains how – some would say “whether” – a model of mutual guarantee can work in a capital-intensive business. It may be that we have not reached the end of scholarly debate on the structures for Islamic insurance.



# CHAPTER 6: TAKING *TAKĀFUL* TO THE NEXT LEVEL

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**Habib Ahmed**

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## Introduction

The theme of this chapter is forward looking – it examines the role and contribution of *takāful* towards a “stable” and “inclusive” financial system in the next 20 years. The notion of inclusive growth in the future can be best exemplified by achieving the Sustainable Development Goals (SDGs) launched by the United Nations in 2015 aiming to eradicate poverty by 2030. There are certain risk mitigation objectives specified in some of the SDGs.<sup>91</sup> As risk and uncertainty increase insecurity, one perspective of sustainability is to consider reduction of vulnerability of households and firms. While various policies and programmes have to be implemented to achieve the SDGs, one of the key factors would be to reduce the risks and vulnerabilities facing all segments of the population, including the poor. Economic units subsisting at the margin are vulnerable, as negative shocks can drive households back to poverty and make firms insolvent.

Stability can be achieved by mitigating the downside effects of risks in the real economy and the financial sector. In contemporary “risk societies”, innovation and globalisation produce various types of new and complex risks that are not well understood (Beck, 1992). The risks arising in an increasingly interconnected world are multidimensional and impact societies across national and regional boundaries (Aven and Renn 2010: 1). Many of these borderless risks are created by human actions and are overshadowing the traditional natural risks. In general, the financial sector mitigates risks directly by providing risk management instruments and insurance services, and indirectly by allocating capital to firms by carrying out due diligence and monitoring. However, the recent Global Financial Crisis (GFC) that impacted economies across the globe, producing costly and deleterious effects, also shows how the financial sector can create new types of risks and cause instability.

The existence of a risk society implies that costs arising from uncertainties can be high and impact inclusive development. Given the prevalence of different types of risks, reducing

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91 For example, Goal 1 – to end poverty everywhere – has two sub-objectives as follows: “1.3: Implement nationally appropriate social protection systems and measures for all, including floors, and by 2030 achieve substantial coverage of the poor and the vulnerable.... 1.5: By 2030, build the resilience of the poor and those in vulnerable situations and reduce their exposure and vulnerability to climate-related extreme events and other economic, social and environmental shocks and disasters.” Similarly, Goal 3, on ensuring healthy lives and promoting well-being for all at all ages, has the following sub-objectives: “3.8: Achieve universal health coverage, including financial risk protection, access to quality essential health-care services and access to safe, effective, quality and affordable essential medicines and vaccines for all.... 3.d: Strengthen the capacity of all countries, in particular developing countries, for early warning, risk reduction and management of national and global health risks.”

insecurity about the future will be a key determinant of enhancing welfare. This would, therefore, require coming up with programmes and schemes that can mitigate the negative effects of new and complex risks. Given the above, this chapter will examine the role that the insurance/*takāful* sector can play in promoting an inclusive and stable financial system and economy. Ascertaining the role and contribution of the *takāful* sector, however, would first require some understanding of the nature of risks and the environment under which the global economy is expected to evolve in the next 20 years.

## Background and Context

Other than determining growth, the way in which risks are managed also plays an important role in providing security to the population in general and the poor in particular. Vulnerability of a household, community or a country depends on the characteristics of risks and the ability to manage them. Risks can be classified as small or large, on the one hand, and as idiosyncratic or systemic on the other hand (World Bank, 2014b). While micro risks are idiosyncratic, arising at the level of individual households or firms, systemic risks are covariant risks that affect communities and national economies. At the micro-level, one of the vulnerable segments of society affected by risks is poor households. The effects of risk events and shocks can be persistent and move households into poverty traps (Carter and Barrett, 2006; Wheeler and Haddad, 2005). At the macro level, systemic risks can not only destroy wealth in the short term, but also affect long-term growth. An example of systemic risks is the recent GFC. Other than its huge monetary cost, estimated to be as high as USD 15 trillion (Yoon, 2012), the crisis also led to large human and social costs.<sup>92</sup>

The nature of risks determines the level at which these can be managed. As idiosyncratic risks are independent of each other, pooling them can reduce the risks faced by individuals through diversification. Systemic risks affect regional and national economies and are difficult to diversify. Parts of systemic risk, however, can be reduced by individual entities by transferring these to those who are better able to absorb and willing to accept them. The different types of risks, and the stakeholders who manage them, are shown in Table 6.1.

**Table 6.1: Types of Risks and Management Roles**

Risk Types	Idiosyncratic	Systemic
Small	Individuals and households	Community and the state
Large	Enterprise sector and financial system	State and international community

Source: Adapted from World Bank (2014b: 20).

<sup>92</sup> Researchers from the Federal Reserve Bank of Dallas estimate the losses from the GFC in the US to be in the range of USD 6–14 trillion. See Atkinson et al. (2013).

Risks can be managed by formal and informal means and at different levels (Holzmann and Jorgensen, 2000). The actors or stakeholders in the risk management framework would be individuals, households, communities, for-profit firms, non-profit organisations, mutuals, the government and international organisations. Jutting (undated; 1999) identifies the instruments and incentives of some of these entities in providing security. The state offers social insurance due to public policy goals, the market provides commercial insurance with an objective of maximising profit, the member-based organisations (MBOs) use mutual arrangements to have solidarity and balanced reciprocity, and finally the households use gifts, loans, and transfers due to social norms and values on the one hand and altruism and self-interest on the other. If asymmetric information and scale of operation problems exist in extremes, the market-based arrangements may not be available. In these cases, there may be a need to provide risk mitigation arrangements by the public bodies.

### Trends and Drivers of Risks

The World Economic Forum (WEF) (2016) categorises global risk exposures into five broad categories: economic, environmental, geopolitical, societal and technological. Note that although the risk types differ, their impact can be quantified into monetary terms. Table 6.2 shows the ranking of different global risks as perceived by experts and decision makers of the WEF over the last decade. The changes in the key risks over the years show the dynamic nature of risks and their evolution. In 2016 the key risk types (likelihood and impact) relate to environmental factors, followed by societal and geopolitical factors.

**Table 6.2: Evolving Ranking of Risk Types in the Past Decade**

Ranking	Likelihood				Impact			
	2007	2011	2016	2016	2007	2011	2016	2016
1 <sup>st</sup>				Large-scale involuntary migration				Failure of climate mitigation and adaptation
2 <sup>nd</sup>				Extreme weather events				Weapons of mass destruction
3 <sup>rd</sup>				Failure of climate mitigation and adaptation				Water crisis
4 <sup>th</sup>				Inter-state conflict with regional consequences				Large-scale involuntary migration
5 <sup>th</sup>				Major natural catastrophes				Severe energy price shock

Economic
 Societal
 Environmental
 Technological
 Geopolitical

Source: WEF (2016: 11).

The OECD (2003a) identifies the key driving forces that can potentially determine risks and uncertainties in the future to be demography, environment, technology and socio-economic structures. Not only is the population expected to increase from the current 7 billion to 9 billion by 2050, thereby increasing consumption and putting strains on resources, but its composition will also change. Whereas in developed countries one-third of the population will be over 60 years by 2050, in the developing countries there will be a need to provide employment to larger numbers of people, which may lead to mass migrations.

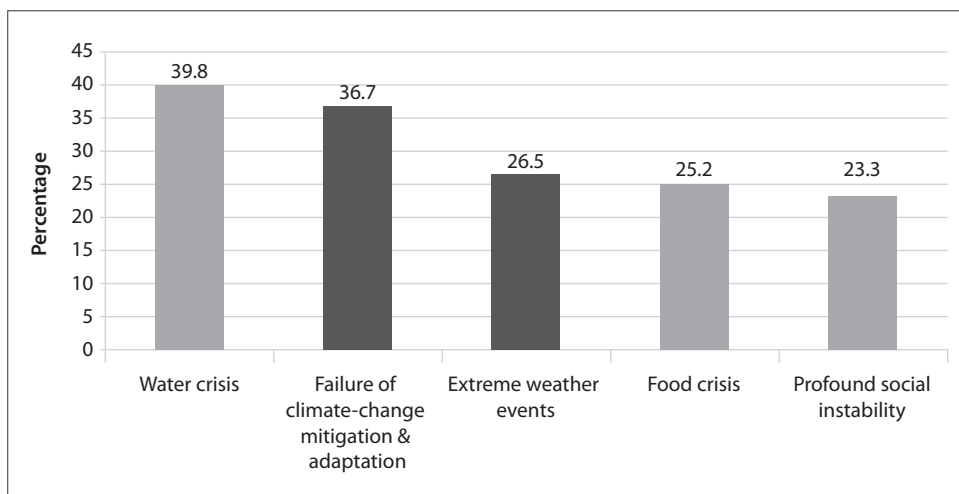
Global warming and climate change are expected to produce extreme weather events that will negatively impact societies and economies. Natural hazards are occurring more frequently and with more severity. The Food and Agriculture Organisation (FAO) (2015) estimates that disasters during 2003–13 caused losses of USD 1.5 trillion, affected more than 2 billion people and killed 1.16 million people. Moving forward, fresh water will become increasingly scarce, with 90% of it being used up by 2030. Lack of fresh water will increase infectious disease and have an adverse impact on the health of populations.

Although technological changes can enhance the pace of development and reduce certain risks, its rapid growth can also introduce certain risks that are complex and not well-understood. Other than cyberspace crime, which is expected to result in estimated losses of more than USD 2 trillion in 2019 (Morgan, 2016; Juniper Research, 2015), the impact of technology on a wide range of other spheres such as biotech, media, politics, identity theft, and so on, will create uncertainties that are difficult to predict.

Finally, in a rapidly changing world, the perception of risks, and of how these are managed in different socio-economic structures, is shifting. While some societies are more proactive in dealing with risks, others show a lack of risk consciousness and fail to take appropriate remedial measures. Different stakeholders such as international bodies, governments, corporations (including the mass media) and civil societies are affecting risk perceptions and their resolutions at different levels. It is difficult to foresee the impact of different types of interventions on the levels and mitigation of risks.

Looking ahead, Figure 6.1 shows the perception by survey respondents of the risks they consider to be most severe in the next decade. Close to 40% of the respondents identify the water crisis as the most severe risk, followed by failure to mitigate and adapt policies related to climate change.

**Figure 6.1: Top Five Global Risk of Highest Concern in the Next 10 Years**



Note: Survey of a total of 742 respondents. Source: WEF (2016: 13).

In line with the WEF, PwC (2012a and 2012b) identifies five key drivers (social, technology, economic, environmental and political – or “STEEP”) of the insurance industry by 2020. Table 6.3 identifies these key drivers, and selected factors within each driver, that will affect the industry in the future. It is interesting to note that the document identifies *takāful* as a political factor that will affect the future insurance industry.

**Table 6.3: Drivers and Factors Affecting the Insurance Industry, 2020**

Key Drivers	Selected Factors
<b>Social</b>	Customer behaviour (social networking, customer expectations, risk awareness, health); demographic shifts (dynamics of middle class, dependency ratio, ageing), corporate social responsibility.
<b>Technology</b>	Information and analysis; devices and sensors; software and applications, medical advances.
<b>Economic</b>	Urbanisation, new growth opportunities, fiscal pressures, risk sharing and transfer, inflation/deflation, social security and benefits.
<b>Environment</b>	Climate change and catastrophes, sustainability, pollution.
<b>Political</b>	Regulatory reform, geo-political risk, terrorism, tax treatment, Sharī'ah compliance ( <i>takāful</i> ).

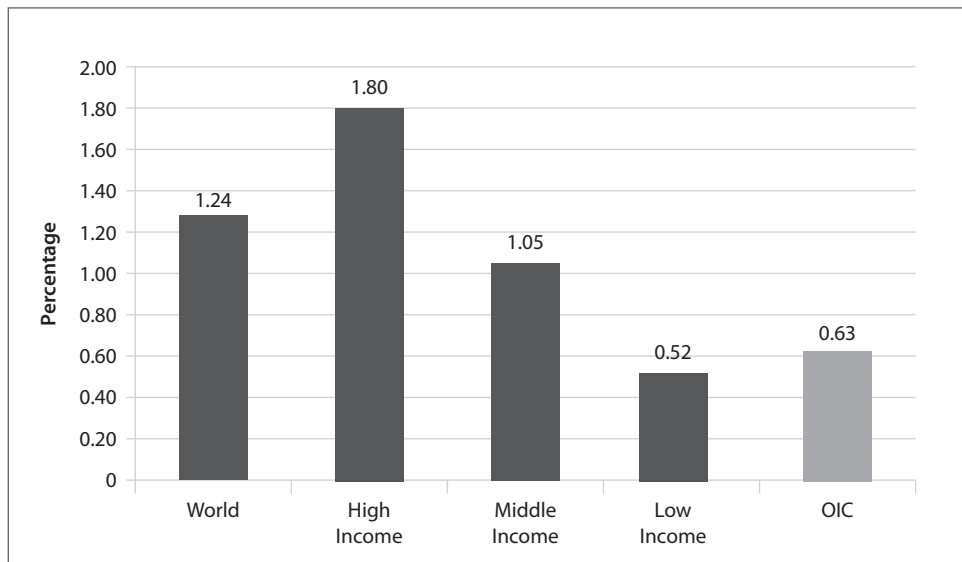
Source: PwC (2012a).

The above discussion indicates that the evolving STEEP drivers provide both opportunities and challenges for the insurance industry in the future. Each of these factors will require appropriate products and approaches that may not be satisfied by contemporary practices. For example, in the socio-economic sphere, Shiller (2003) identifies six key risk allocation and management areas that may be relevant in the 21st century. These are: (1) insurance for livelihood and home value; (2) macro-markets for trading economy-wide risks; (3) reducing the risks of hardship and bankruptcy; (4) inequality insurance to protect the distribution of income; (5) intergenerational social security; and (6) international agreements to control global risks.

### ***Takāful: Status in OIC Member Countries***

Sharī'ah as indicated, the key functions of managing and mitigating risks are performed by the insurance/*takāful* sector. Figure 6.2 shows the penetration of the insurance sector in a sample of 44 OIC member countries (MCs) relative to countries in different income groupings. Though higher than the average for the low-income countries, the penetration of the insurance industry in OIC MCs (0.63% of GDP) is almost half that of the world (1.24%), indicating a relatively underdeveloped sector.

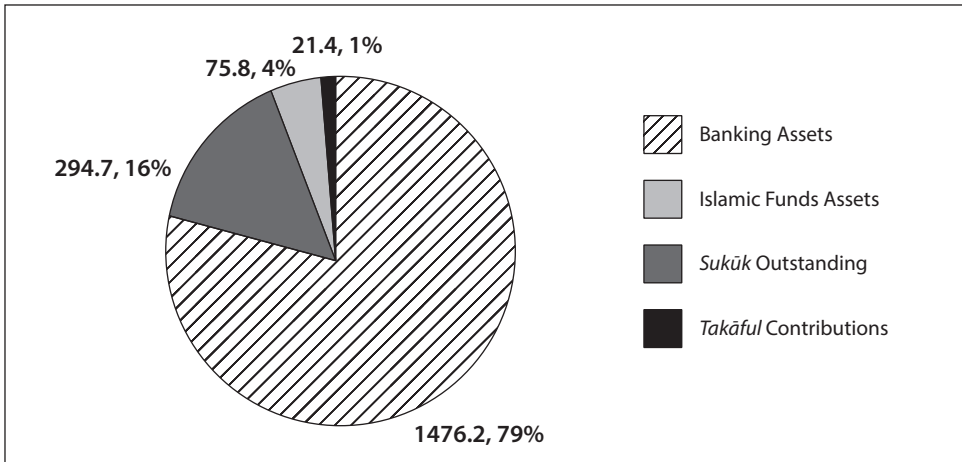
**Figure 6.2: Non-life Insurance Premium Volume to GDP (%)**



Source: Calculated from World Bank Global Financial Development database.

Figure 6.3 shows the size of the *takāful* sector in the global Islamic industry. Of the estimated USD 1.87 trillion of total global Islamic financial assets in 1H2014, Islamic banking assets account for USD 1.47 trillion, or 79% of the total assets. With USD 21.4 billion in *takāful* contributions globally, the sector represents only 1.1% of the total Islamic financial assets (IFSB, 2015).

**Figure 6.3: Islamic Financial Sectors, 2014 (US\$ billion, Percentage of Total)**



Source: IFSB (2015).

### **Takāful In the Next 20 Years**

Managing risks in the future will not only require identifying the key risks that may impact societies, but also recognising that attitude towards risks and their management have cultural and legal (Sharī'ah) connotations. While the evolving risks in the future will require new products and approaches, for a large percentage of the low-income population the basic insurance needs are not fulfilled. Given the low penetration of insurance in general – and *takāful*, in particular – in the OIC MCs, the future challenge for the latter would be two-fold. The first challenge will be to expand *takāful* services to cover the traditional risks faced by different stakeholders. This will include providing typical insurances such as property, life and health. For example, Swiss Re (2010) identifies four key risk types that low-income families face:

- (a) Health risks, which result in either direct costs due to unexpected medical treatment or indirect losses of income due to health-related reasons.
- (b) Risk related to life-cycle events, such as old-age and death of the bread-winner in the household.
- (c) Financial risks that result in lower income due to various reasons, such as loss of property, decrease in price of products, crop failure, etc.

- (d) Households face disaster risks arising from natural events that can cause loss of life and property. In a survey of insurance providers in 11 countries, Roth et al. (2007) find demand for protection against health risks to be ranked highest, followed by property and death risks.

The second challenge, given the evolution of risks in the future, there will be a need to come up with new products that can mitigate these risks. The right way to deal with these risks would depend on their nature and scope. For example, risks that are idiosyncratic, and others that are systemic, would require different types of responses. As indicated above, risks can be managed by formal and informal means and at different levels, such as the household, community, market and government levels. The type and sources of risks will determine the appropriate level at which they can be managed. For example, while micro-level risks can be managed by various informal means by the household and the community, macro-level risks will be difficult to manage at these levels. Similarly, if asymmetric information problems exist in extremes, the market-based arrangements may not be available. In some cases, there may be a need for the government to provide risk mitigation arrangements to support the poor and the vulnerable.

Given the above, strategising on managing risks in the future can thus be discussed under two broad headings: policies at the state/public level; and specific initiatives at the market/organisational level. Other than the need for public policy to manage risks, areas in which innovative approaches can be adopted to deal with current and future risks need to be identified. These are presented next.

### ***Public Policies towards Allocation and Management of Risks***

There is a need to pay more attention to risks in public policy matters in risk societies. Whereas wealth is tangible and risk is intangible, the latter can cause real adverse impacts on wealth and welfare. Evidence shows that wealth distribution is skewed towards the rich, and that risks are concentrated among people with lower incomes. One implication of the inverse relationship between wealth and risk is that resources (such as higher income and education) can be used to reduce the latter. Beck (1992) proposes that, similar to wealth, risks should also be objects of distribution. Just as distribution of income and wealth has ethical and social policy relevance, distribution of risks would have similar connotations. Given the above, there is a need to have a public policy framework for how risks are allocated and managed at different levels, particularly for the poor.

The prevalence of a wide range of risks necessitates having an appropriate infrastructure that raises awareness and promotes the culture of risk management. Some of the public-private partnership issues that are important in this respect are identified by Mahul and Skees (2007) when dealing with risks in agriculture. The areas of cooperation include: (1)



data collection and sharing information related to historical events, fraud and abuse; (2) sound regulatory and supervisory regimes for *takāful*/insurance and consumer protection; (3) technical expertise for managing different kinds of risks; and (4) risk financing entities at the public level catering to the risks that cannot be managed at the private level at a reasonable cost. The public sector should also use other appropriate risk financing strategies, such as reserve fund, contingent credit facilities, and so on, and disseminate information and education to raise awareness of risks and their mitigation.

The role of supportive and sound regulations in developing a robust *takāful* sector has been covered extensively in other chapters of this volume. A key issue is to encourage the establishment and operations of different organisational formats of *takāful* operators that include cooperatives and fintechs and also have varied regulatory treatments depending on their size and outreach. For example, smaller cooperative-type *takāful* structures should have lenient capital and solvency requirements compared to their commercial counterparts.

### **Market/Organisational-Level Initiatives**

Given the small size of the *takāful* sector, its future roles can be viewed as:

- (a) catching up with the conventional insurance industry by filling gaps in the services that the sector is providing in developed economies; and
- (b) developing innovative solutions to manage the new risks of the future.

Some of the specific areas in which the *takāful* sector can contribute to mitigating the risks in the above two categories are identified below. Note that while the first three areas belong to the first approach identified above, the latter four areas represent the second approach.

#### **Micro*takāful* Services**

As the risks that households face in the short term can be mitigated by different types of *takāful* products, the obvious way to achieve financial inclusion is to provide these services to the poorer sections of the population. The potential global market for microinsurance products is estimated at 3 billion individuals (Lloyds, 2009: 24). There are two main types of *takāful*, general and family, that should be provided to the poor. While the former provides short-term protection against accidents and losses of property, the latter provides saving opportunities and long-term protection arising from death or disability. The types of products under family *takāful* have become diverse, providing a variety of products that can be used for wealth and lifestyle protection. The products under family *takāful* include investment-linked family *takāful*, mortgage *takāful*, and so on. Similarly, micro- and small firms need to mitigate risks by taking up *takāful* to protect specific assets. The key providers of *microtakāful* would be financial institutions and non-profit organisations.

### Health Insurance

Progress in the overall health facilities is considered crucial to promoting development and reducing poverty (IMF, 2004: 1). As mentioned, health problems add to costs on the one hand and result in income losses on the other hand. Several studies confirm that protection against health risks is given the top priority among the uncertainties and is most demanded by most communities (Lloyds, 2009: 25). Whereas some of the commercial *takāful* companies can provide protection against specific health issues such as outpatient visits and hospitalisation, there may be a need for schemes providing comprehensive coverage, such as state-supported universal health care. However, this may be difficult in countries with a low tax base and revenues. An alternative is to come up with community-based non-profit health insurance/*takāful* schemes operating under the principle of risk sharing (Carrin et al., 2005: 780).

### Tackling Longevity and Intergenerational Risks

While products for management of longevity/livelihood risks and old-age care are also important during contemporary times, this will become more important in the future as people are expected to live longer and a larger percentage of the population is expected to be elderly. Family is the basic unit of a society, and Islam places great value on its integrity and functioning. One of the functions of a family unit is to provide an opportunity for economic security for all its members. Other than rights and obligations that define the roles of the members, Islam instils certain values of compassion and care that can enhance security and welfare in families. Given this framework, issues related to dealing with livelihood risks and old-age care need to have the family unit as the focal point. The Islamic viewpoint on different risks related to households thus requires careful study and scrutiny to produce balanced solutions involving the family, market and government.

### Fintechs and Using Technology-based Delivery Systems

One of the problems of providing microinsurance is higher costs. Along with high risks, high transaction costs associated with a low scale of operation and low demand can lead to a situation where the costs of provision of microinsurance become exorbitantly high and its sustainability becomes difficult. The cost of providing insurance is high due to the small size of insurance coverage, as the transaction cost increases due to the lack of economies of scale and of contract enforcement mechanisms (Morduch, 2006). The implication of the above is that, until a certain scale of operation in terms of client numbers is reached, provision of microinsurance may require subsidies (Mosley, 2003: 147). One way to minimise the costs of delivery is to introduce fintechs that use technology to deliver services. While fintechs are relatively new, and Islamic ones are very few, most of the fintechs deal with providing financing. There is a need to develop models that integrate *takāful*/insurance in these technology-based

financial institutions of the future.

### **Revival of *Zakat* and *Waqf* as Risk-sharing Institutions**

Poverty is directly linked to reducing the risks and vulnerability of poor households. Vulnerability of the poor relates not only to the severity of risk, but also to the ability of an individual or household to absorb the shock, either by means of assets or some insurance mechanism. In this regard, the social institutions of *zakat* and *awqaf* (plural of *waqf*) played an important role in Muslim societies as risk-sharing institutions in the past. There is a need to revive these traditional religious social institutions as tools of risk mitigation for the poor during contemporary times and the future.

### **Mitigating Environmental Risks**

Environmental and natural hazards from global warming and climate change are expected to become more severe in the coming years. As these risks are large and systemic, the insurance/*takāful* sectors may not be able to provide adequate coverage against them. There may be a need for states to come up with schemes to deal with these risks in an appropriate way. An example of a scheme to manage these large and systemic risks is the Turkish Catastrophic Insurance Pool, created after the earthquake of 1999. This scheme is a combination of measures, including making insurance compulsory, public provision of coverage up to a ceiling, and options of using complementary market-based insurance and reinsurance of the pool (OECD, 2003a).

### **Expanding the Scope of *Takāful* to Cover Non-traditional Risks**

As Islamic law prohibits the selling of risks, derivative instruments cannot be used to transfer risks in an Islamic economy. This calls for broader use of risk-sharing schemes to mitigate and distribute risks. In this regard, the concept of *takāful* can be used to deal with a larger number of non-traditional risks. For example, to deal with liquidity risks, Islamic banks can form a cooperative *takāful* structure. A pool can be established either at the private level (such as an investment bank, *takāful* operator or association of banks) or the public level by the central bank. The income of the pool will be fees for providing the services. Participation in the scheme would allow banks to take interest-free loans from the pool in case of need.

Another key risk that needs to be dealt with will be cyber risk. This is an area that is new even for the conventional insurance sector. However, given the role that technology will play in the future, and the risks associated with it, a response is required to protect against these. If *takāful* can come up with a cooperative format through which this new and real risk can be shared and mitigated, it can be a potential solution for all stakeholders.

## Conclusion

Inclusive development entails growth that benefits all segments of the population. Moving forward, the types and intensity of different types of risks will require innovative solutions at different levels. In future risk societies, risk management and sharing schemes will become vital to reduce the negative impacts of uncertainties and to promote inclusive development. The topography of current and future risks indicates that while some risks need to be dealt with at the government level, others need to be tackled by the insurance/*takāful* sector. In particular, the landscape of risks provides opportunities and challenges to the insurance sector in general and the *takāful* industry in particular. As the penetration of *takāful* in most Muslim countries is low, the industry not only has to provide traditional insurance/protection products, but also to develop newer ones that can deal with the novel risks and uncertainties of the future. This would require a supportive regulatory regime under which innovative organisations, products and delivery systems can be developed to provide *takāful* services efficiently and effectively in the coming years. Given that *takāful* can provide risk-sharing products that are able to minimise the harmful effects of risks, it has the potential to provide alternative products that can serve the current and future needs of both Muslim and non-Muslim clients.

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# CHAPTER 7: SYNTHESIS OF DISCUSSIONS AND A WAY FORWARD

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**Habib Ahmed**

## Introduction

Insurance is one of the essential financial services for both the household and business sectors in contemporary economies that are prone to various types of risks. However, many Muslims are reluctant to take up conventional insurance as it is deemed to have *gharār* and *maysir*, which are prohibited by Sharī'ah. Thus, providing *takāful* services to all segments of the population becomes a vital tool for financial inclusion for mitigating risks and enhancing economic lives. This is particularly true for the poor, who are vulnerable to negative shocks and need protection against uncertainty. The current penetration level of insurance/*takāful* in OIC member countries is very small, showing promise for growth. Furthermore, prevalence of different types of new risks will also increase the demand for *takāful* services in the future.

The chapters in this volume have examined various aspects of the *takāful* industry and identified different factors that need to be dealt with for the industry to grow further. While the current low levels of penetration and future needs show significant growth prospects for the *takāful* sector, some factors will determine the potential and the levels that the industry will be able to reach. This concluding chapter examines the key issues discussed in the previous chapters and identifies some of the steps that need to be taken for robust development of the *takāful* sector in the future.

## Regulatory Regimes

Sound growth of any financial industry and protection of stakeholders require a supportive legal and regulatory regime. Llewellyn (2006) identifies the functions of regulators as including setting up the regulatory framework in the form of prudential regulations related to conduct of business and the safety and soundness of financial institutions, and providing safety net arrangements. Other functions include ongoing oversight and supervision, such as prudential supervision of financial institutions and conduct of business supervision, liquidity assistance for systemic stability, and ensuring the stability and integrity of the payments system and markets. Carvajal et al. (2009) further identify the issues that regulators consider at the institutional level. The first relates to requirements for an overall sound governance and risk management framework. The second feature is related to controlling risks and imbalances in the balance sheet. This aspect of the regulation would require holding adequate capital and liquidity. The final aspect relates to protecting stakeholders by enforcing information and disclosure requirements.

In the opening chapter, Gonulal (2017) highlights that the hybrid feature of the *takāful* model of mutual and commercial elements raises significant regulatory issues. Regulations related to *takāful* in most jurisdictions are evolving, which can create uncertainties. Lack of standardised *takāful* models and an accompanying regulatory framework can lead to confusion and may adversely affect the growth of the industry. In the absence of a regulatory framework for *takāful*, regulators often treat *takāful* operators similarly to insurance that assumes risk transfer with guaranteed benefits. This leads to capital and solvency requirements that are similar for both *takāful* and insurance (Gonulal, Chapter 1). Thus, there is a need for a standardised regulatory regime that deals with issues arising from the unique feature of the hybrid model of *takāful*. This is needed not only in order to come up with appropriate prudential regulations for *takāful*, but also to protect and instill confidence among the participants.

The overall regulatory standards for the insurance industry are the Insurance Core Principles (ICP) set at the international level by the International Association of Insurance Supervisors (IAIS). However, recognising the unique features of *takāful*, the Islamic Financial Services Board (IFSB) has developed standards and principles for the sector. To date, the IFSB has issued three standards related to the *takāful* sector (IFSB-8, IFSB-11 and IFSB-14) and IFSB-18 for the *retakāful* sector. Use of these standards can provide a harmonised regulatory framework which is needed for the future growth of the *takāful* sector, particularly for organisations that are engaged in cross-border business. In line with the regulatory framework of the IAIS, Smith (Chapter 2) identifies the key pillars of a sound regulatory regime for insurance/*takāful*: capital adequacy, governance and risk management, and disclosure to both the regulators and the public. IFSB-11 deals with the solvency requirements of *takāful* companies by acknowledging the key features of the *takāful* model. One of the key issues is the role of shareholders' capital in serving as capital for the participants' risk fund (PRF). As indicated above, in case of a deficit in the PRF, the *takāful* operator provides *qarḍ* to the fund that is recovered later. The regulators need to identify clearly how *qarḍ* is used and recovered so as to ensure the sustainability not only of the PRF but also the *takāful* company. Smith (Chapter 2) points out some issues that regulators need to pay attention to, such as at what point the *qarḍ* would be able to permanently absorb the losses in the PRF. Stiffl (Chapter 5), however, raises a Sharī'ah issue related to the regulatory requirement of using *qarḍ* to cover the deficits in the PRF. In principle, *qarḍ* should be voluntary and not obligatory, which is the case in most regulatory frameworks. He notes, however, that IFSB-18 clarifies that by providing *qarḍ*, the *takāful* operator is not underwriting the risks of the PRF, but instead is exposed to credit risk.

One way to deal with limiting the use of *qarḍ* would be to come up with a regulatory framework for determining fees that the *takāful* operator charges in a *wakālah* model. A key variable that determines whether the PRF is in persistent deficit is the *wakālah* fees charged



by the *takāful* operator. One way to deal with this, from a regulatory perspective, would be to require an actuary to determine the amount needed in the PRF that is sufficient to cover indemnities for determining the fees/prices. This is done in Bahrain, as indicated by Kassim in Chapter 4.

As indicated, the second pillar of the regulatory regime for insurance/*takāful* is risk management and governance. Accordingly, some of the international ICPs emphasise regulatory overview of sound risk management and good governance. The IFSB has come up with principles and standards that deal with these aspects, with IFSB-8 dealing with governance and IFSB-14 providing principles of risk management for *takāful* (Smith, Chapter 2). Among the issues that need attention are segregation of the funds of shareholders and participants, and the need to deal separately with different PRFs.

The third pillar of a sound regulatory framework is disclosure of relevant information to both the regulators and the stakeholders. Given the feature of PRF in a *takāful* model, disclosure of different aspects of operations related to PRF becomes very important. As, in principle, the participants own the PRF and the *takāful* operator manages it, information on the total collections, the fees paid to the *takāful* operator, the surplus/deficit in the PRF, the size of the reserves, surplus distribution, and so on, must be disclosed to them. Gonulal (Chapter 1) maintains that transparency is a key problem in *takāful* and identifies a few issues arising in the industry. Areas of improvement include a simple standard policy form that is customer friendly, and information that clearly shows the relationship between the *takāful* operator and participants, the operators' fees and profit share, and the distribution of surplus.

One of the unique features of the regulatory overview of Islamic finance relates to Sharī'ah governance. IFSB-10 provides the guiding principles of Sharī'ah governance that also apply to *takāful* operators. Although IFSB-10 does not require a central Sharī'ah board that can standardise the rulings and reduce the costs of Sharī'ah governance at the organisational level, from a regulatory perspective such a body can instill confidence among the market participants and reduce the Sharī'ah compliance risks, as indicated by Kassim (Chapter 4) and Smith (Chapter 2).

Some issues arise in regulating *takāful* and *retakāful* groups that operate in different jurisdictions. The regulator of the parent company has to consider the risks arising from other jurisdictions. While adopting international regulatory standards can mitigate these regulatory risks, another option is that regulators and supervisors communicate and cooperate to address the issues across jurisdictions (Smith, Chapter 2). A key issue that can constrain cross-border activities is the differences in Sharī'ah interpretations. IFSB-18 provides guidelines for regulating the *retakāful* sector that can help harmonise the business model and promote its growth. Stiffl (Chapter 5), however, points out that while IFSB-18

covers the Sharī'ah-related issues in the *retakāful* model in detail, it does not deal with certain technical issues arising from the complexities of a model that is cooperative and commercial. He also suggests the use of other, alternative structures, such as closed pools and syndicates and mutual as models of *retakāful*.

Brugnoni (Chapter 3) discusses regulatory issues arising in *microtakāful*. As the premium contributions from microentrepreneurs and the poor are small and the risks are high, stringent regulatory solvency capital and contingent reserve requirements would inhibit organisations venturing into this segment. He suggests that the regulatory requirements for this segment should be more flexible to encourage non-profit organisations to come forward to provide *microtakāful* services. In this regard, the capital requirements for discretionary mutuals that pay benefits that are not fixed or guaranteed to provide *microtakāful* services can be set at a lower level (Brugnoni, Chapter 3). Furthermore, surplus from the PRF can be accumulated as reserves that can serve as solvency capital.

Moving forward, there is a need for countries to adopt the IFSB standards on *takāful* that provide a harmonised regulatory framework. Introduction of regulations that consider the special features of *takāful* will bring about confidence in the sector among the stakeholders and help to promote the future growth of the sector, particularly for organisations that are engaged in cross-border business. To enable the implementation of the standards would also require enhancing the capacity of regulators to develop an appropriate legal and regulatory framework that suits their *takāful* models (Gonulal, Chapter 1).

## **Takāful Models**

While the focus of the discussions on the need for an alternative to insurance relates to prohibitions on the selling and transferring of risks in Sharī'ah, Brugnoni (Chapter 3) asserts that the *takāful* concept has wider ethical implications beyond the concept of risk sharing. The principles of solidarity, mutuality and charity entailed in the principles of *taāwun* and *tabarru'* underpin the *takāful* model. The appropriate organisational format that reflects these values and principles would be a cooperative structure. Most of the contributors to this volume, such as Brugnoni (Chapter 3), Kassim (Chapter 4) and Stiffl (Chapter 5), have discussed fundamental issues related to the hybrid *takāful* model being used in practice which entails both a commercial component (related to the *takāful* operator) and a mutual component (related to the participants). Kassim (Chapter 4) points out that the adopted commercial model introduces some inherent contradictions to the *taāwun/tabarru'* concepts. In reality, the participants do not share the losses of the PRF. Instead, to sustain the PRF in times of deficit, the *takāful* operator has to provide *qard*, which is recovered later. Stiffl (Chapter 5) alludes to the Sharī'ah concern of using *qard* to cover deficits, as it dilutes the risk-sharing feature of the *takāful* structure. This feature, along with the commercial nature of the *takāful*

operator, raises some questions about the *takāful* model and its uniqueness. This has led to Kassim (Chapter 4) and Gonulal (Chapter 1) arguing that the most appropriate term for the hybrid model of *takāful* is “Sharī’ah-compliant insurance”.

While the hybrid model of *takāful* can meet the insurance demands of Muslims by providing Sharī’ah-compliant services, there is a need to develop alternative *takāful* structures. This is particularly important in light of the OIC International Fiqh Academy ruling of 2013 which declared the non-profit cooperative model to reflect the true spirit of the *taāwun* concept, as indicated by Stiffl (Chapter 5). Exploring models of *takāful* that are truly cooperative in nature would diversify the organisational formats that the *takāful* industry can offer, as can be found in the conventional insurance industry, which has both commercial and cooperative models. This would require not only discussing the appropriate conceptual Sharī’ah-compliant cooperative models that use the concept of *taāwun*, but also coming up with operational models of cooperative *takāful* that can be implemented in reality. Brugnoni (Chapter 3) suggests a model of discretionary mutuals where the benefits payable are not fixed and guaranteed as a way to provide *microtakāful* services.

One option for introducing non-profit cooperative models may be to integrate *takāful* with the charity-driven institutions of *waqf* and *zakat*, as suggested by Ahmed (Chapter 6), Brugnoni (Chapter 3) and Gonulal (Chapter 1). In some countries such as Pakistan, *waqf* is an integral part of the *takāful* model whereby the PRF is established as *waqf*. There is flexibility in establishing *waqf*-based *takāful* models as long as this is included in the *waqf* deed. While there are no Sharī’ah restrictions on using *waqf* for cooperative structures that provide *microtakāful* to the poor, certain conditions must be fulfilled in the case of *zakat*. The condition of the *tamlīk* stipulates that *zakat* must be transferred to the recipient. In this respect, while *zakat* can be used to pay the participants’ contribution to the PRF and protect them against negative shocks, coming up with a *takāful* model that integrates *zakat* in other ways would need further research and study.

Recognising that insurance/*takāful* is sold and not bought (Kassim, Chapter 4), there is a need to explore different delivery channels of *takāful* services. Besides the *takāful* operator, Gonulal (Chapter 1) identifies other distribution channels that can be used to reach the poor. These include partnership between a *takāful* operator and an Islamic microfinance institution, community-based model, provider- (such as hospital or cooperative) based model and social protection-based model. As establishing new distribution channels can be costly, one option would be to allow *takāful* windows to operate in established insurance companies. However, care needs to be taken to keep the funds and business of insurance and *takāful* separate and segregated (Gonulal, Chapter 1).

As is the case of reinsurance, *retakāful* is needed to protect the industry from large, impactful negative shocks. However, *retakāful* is one of the weaker segments of the *takāful* industry. This is due partly to the capital-intensive nature of the *retakāful* sector and to the fact that the *takāful* industry is relatively small, which makes ensuring sustainability of *retakāful* companies difficult if they are operating in a single or small number of jurisdictions. Stiftl (Chapter 5) argues that a cooperative structure for reinsurance operating in Germany can be used to model *retakāful*, particularly because its essence is risk sharing in nature. The cooperative structure also tackles the problem of high capital requirements that is typical of reinsurance companies. However, Casey points out that a mutual model for *retakāful* may not be commercially viable. Instead, he suggests establishing *retakāful* using some variant of the current hybrid *takāful* models, but with significant capital to deal with extreme outcomes.

## Markets, Products and Delivery Channels

Gonulal (Chapter 1) and Ahmed (Chapter 6) show that insurance penetration in the OIC member countries is very low in general, and that *takāful* constitutes a small fraction of the overall insurance industry. The growth of the *takāful* sector during the recent past has been impressive given the low penetration along with high demand for religious reasons. Furthermore, Ahmed (Chapter 6) identifies different types of risks and uncertainty that are expected to increase in the future and that require appropriate risk mitigation and management responses which can further increase the demand for *takāful* services. Thus, the recent high growth rate of the *takāful* sector is expected to continue and to accelerate further in the future.

While the overall growth of the global *takāful* industry has been impressive, the bulk of the growth in *takāful* can be observed in a handful of markets. Gonulal (Chapter 1) points out that the spread of the *takāful* industry is uneven, with four countries accounting for 90% of the total global market. As indicated, the low penetration rates of insurance in general and the small proportion of *takāful* in the insurance sector create room for future growth of the insurance market. A key factor from the demand side, however, is the lack of understanding of the *takāful* models among the public. Participants are not aware of the different models of *takāful* and that they own the participants' risk fund. There is a need for consumer protection and financial literacy programmes that would enhance the awareness and knowledge of the participants. In particular, the participants should be aware of the underlying *takāful* model being used (*wakālah*, *muḍārabah*), the rights of the participants in terms of the surplus distribution, and that the *takāful* operator provides *qarḍ* to the PRF when it is in deficit. The lack of understanding of the *takāful* models can lead to a perception that they are no different from their conventional counterparts.

Among the external risks is the demand for *takāful* services. While many Muslims would deal with *takāful* for religious reasons, the overall take-up of *takāful* services among Muslims appears not to be overwhelming (Kassim, Chapter 4). This is partly because they do not see any difference (particularly when no surplus is distributed) and partly because they perceive the quality of the services to be poor. However, in developed markets such as Malaysia, a significant percentage of the clients of *takāful* operators are non-Muslims. This can be partly explained by the tariffs imposed by the government. While the premiums charged by both insurance and *takāful* are governed by tariffs, distribution of surplus provides a price advantage for policyholders. However, this advantage would disappear if the surplus is not distributed to the participants. Given the above, the *takāful* industry has to come up with competitive products, along with good services, to capture a larger share of the market.

A key market segment that remains underserved or unserved is the *microtakāful* sector. However, as the premium for this segment is small and the risks are considered high, the commercial–cooperative hybrid *takāful* operators have not been forthcoming in serving this market. Given the social orientation of Islamic finance, this segment can be well served by *takāful*. As the hybrid commercial–cooperative *takāful* industry is not providing services to this market segment for economic reasons, alternative models that have social goals need to be developed. As some of the *microtakāful* would not be driven by profit, Gonulal (Chapter 1) suggests promoting private–public partnerships to increase financial inclusion. Moving forward, Ahmed (Chapter 6) suggests using fintechs to provide services to the poorer sections of the population to reduce the costs of delivery.

While the *takāful* industry needs to expand to increase the current penetration of different types of *takāful* products such as *microtakāful* and health, the evolution of a dynamic globalised economy in the future will introduce newer types of risks and increase the demand for insurance and *takāful* services. Ahmed (Chapter 6) identifies some of the new areas in which *takāful* protection may be needed, including longevity and intergenerational risks, environmental risks and cyber risks. In this regard, *takāful* can provide an ethical alternative and capture a large share of the market by coming up with risk-sharing alternatives that have value provisions for all segments of the population, including the poor.

## Corporate Governance

Strengthening corporate governance is essential for the long-run sustainability of the *takāful* sector. A key weakness of the hybrid *takāful* model is its governance structure, whereby a mechanism through which the participants have a voice in governance is absent. Situations can arise in the *takāful* model where the interests of shareholders and participants are conflicting. If there are cases of conflict between shareholders and participants, there is no opportunity to present the views of the latter. Gonulal (Chapter 1) suggests that

regulators should take steps to ensure that the interests of the participants are protected and a mechanism created so that views are represented on the board. Kassim (Chapter 4) suggests establishing a separate “participants’ board” to address the interests of the participants. However, while this suggestion is sound, it may create conflict with the concept of the *muḍārabah* model. Specifically, in *muḍārabah* the *rabb-al māl* does not have the right to interfere in the activities of the *muḍarib*. This would make it difficult for investors/participants to claim any representation on the board. (The problem is somewhat similar to the profit sharing investment account in Islamic banks.)

Gonulal (Chapter 1) also suggests that regulators should provide a framework for corporate governance that would include issues such as clearly defining the roles and responsibilities of the board of directors, the Sharī’ah board and actuaries. Kassim (Chapter 4) also suggests organising the PRF as a trust, with the *takāful* operator acting as a trustee with fiduciary duties to look after the interests of the participants. In this regard, the *waqf* model would also be appropriate. If the PRF is structured as a *waqf*, a board of *mutawallis*/trustees can look after the interests of the participants.

There is potential for a moral hazard problem in the *wakālah* model whereby the *takāful* operator may not have an incentive to manage the PRF diligently as its income does not depend on the returns from the pool. This can be partly remedied by using a hybrid model whereby part of the revenue of the *takāful* operator comes from *wakālah* fees and part as a share of the surplus generated by managing the PRF. One key issue in governance is disclosing relevant information on PRF to the participants. If this is not done by the *takāful* operators, the regulators should require this.

## Risk Management

The hybrid *takāful* model of propriety and cooperative insurance introduces some risks. The first issue relates to the role of capital in absorbing underwriting risks. In conventional insurance, while a surplus translates to shareholders’ profits, a deficit would mean that the capital is at risk. In *takāful*, while the surplus is distributed to participants, in case of a deficit in the PRF, the *takāful* operator provides *qarḍ* which is recovered later. In other words, the cooperative component does not have capital and uses the capital of shareholders in case of need. One way to deal with this may be to create reserves with the surpluses that can be used to cover deficits.

Several authors – Gonulal (Chapter 1), Kassim (Chapter 4) and Stiffl (Chapter 5) – have identified issues related to the solvency of the PRF. In this regard, the *takāful* operator has to deal with two key interrelated internal risks. The first relates to underwriting and focuses on pricing risks. On the one hand, if the prices are too high, the operations may

become uncompetitive. On the other hand, if the contributions are priced too low to gain market share, there is a possibility of the PRF being in deficit. Furthermore, as most of the *takāful* are relatively new, they face challenges in competing with existing larger insurance companies that benefit from economies of scale. This makes pricing of products a key issue in *takāful* operations, which has implications for the distribution of any surplus – one of the distinguishing features. If the contributions are priced competitively but no surplus is distributed, then the participants would fail to see any difference between *takāful* and insurance.

The second risk is operational and relates to determining the fees for the *takāful* operator, which is more relevant for the *wakālah*-based model. Again, a higher level of fees would increase the revenue of the *takāful* operator, but it can potentially lead to deficits in the PRF, which would require *qarḍ* from the *takāful* operator. A lower fee would reduce the *takāful* operator's revenue, but keep the PRF solvent. Thus, the level of fees becomes an important variable determining the solvency of the PRF and the extent to which *qarḍ* would be required.

There are issues related to the Sharī'ah compliance risks. In the absence of a central Sharī'ah board, there is the possibility that different fatāwas and Sharī'ah compliance risks can arise. In this regard, a key issue relates to the participants' perceptions of Sharī'ah compliance. Furthermore, *takāful* operators have to incur the costs of Sharī'ah governance, which makes them less competitive compared to conventional insurance companies. One way to deal with Sharī'ah-related issues is to have a central Sharī'ah board that, among other things, develops Sharī'ah parameters. This will not only reduce the costs of Sharī'ah governance in *takāful* operators, but also reduce Sharī'ah compliance risks and instill confidence among the participants.

## Other Operational Issues

### **Competition**

While *takāful* may have a captive market of consumers who would prefer, for religious reasons, not to deal with conventional insurance, they also face competition from other *takāful* operators and insurance companies. In the *takāful* market, price competition can lead to less or no surplus being distributed, which would make participants believe that *takāful* operations are no different from conventional insurance. *Takāful* operators face competition from established conventional insurers who have an advantage due to their large size and economies of scale. Most of the *takāful* companies are start-ups and have to deal with the trade-off between market share and profitability in this competitive market. On the one hand, while lower competitive



premiums will enable them to attract customers, it may result in losses; on the other hand, higher premiums would result in losing market share (Gonulal, Chapter 1). Kassim (Chapter 4) also points out another disadvantage that *takāful* operators face relative to their conventional counterparts: while conventional insurance has to bear the underwriting risks, it alone benefits from underwriting surplus. However, *takāful* operators have to support the PRF in case of deficits by providing *qarḍ* and do not benefit from the upturns, as the surplus belongs to the participants.

### ***Sharī'ah-compliant Securities/Instruments***

For the *takāful* sector to function in an optimal manner there is a need for short-term and long-term Sharī'ah-compliant assets in which the *takāful* companies can invest. Thus, development of the Islamic capital markets is complementary to the development of the *takāful* sector. The lack of diversified Sharī'ah-compliant assets in which *takāful* companies can invest their funds would put them at a relative disadvantage compared to their conventional counterparts. Some of the authors (such as Gonulal, in Chapter 1, and Kassim, in Chapter 4) have highlighted that the lack of Sharī'ah-compliant instruments/*sukūk* in which *takāful* operators can invest affects the investment strategy of *takāful* operators. Not only are these instruments insufficient, but they lack liquidity, partly due to deep and efficient financial markets in most jurisdictions.

### ***Qualified Personnel***

Gonulal (Chapter 1) asserts that the lack of personnel who understand the unique features of *takāful* can create operational problems. Most *takāful* operators hire staff with a conventional insurance background who may lack knowledge of the features of *takāful* operations and the expectations of clients. She suggests that training personnel with the right skills and knowledge will be an important element in the future development of the *takāful* industry.

## **Conclusion**

As alleviating the negative consequences of risk and uncertainty is closely linked to sustainable development, the growth of the *takāful* sector will be closely linked to the economic development of the Muslim world, as emphasised by Gonulal. The current status of the *takāful* sector vis-à-vis the potential market demand shows the huge potential that the industry has to fill the gaps. In the future, there is scope for the *takāful* sector to contribute even more, as the different types of risks are expected to increase and thus would enlarge the demand for protective schemes. To be acceptable by Muslims, the models and approaches used to mitigate risks need to comply with their religious beliefs and norms.



Given its ethical origins and risk-sharing feature, the *tafa'kul* sector has the potential to play a greater role both in meeting the current demand and in serving the increased need to deal with different types of risks in the future, not only for Muslims but for the larger population. However, as indicated in the deliberations, the sector faces challenges at different levels that need to be resolved if it is to realise its full potential. While some of these obstacles relate to issues such as regulations and operations, meeting future needs would require developing newer and innovative *takaful* organisational models, products and delivery systems. As indicated by Kassim (Chapter 4), the time has arrived to think beyond the traditional templates and to consider alternative innovative models that can serve the need for risk management efficiently and effectively in this age of Uber and Airbnb.

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## CONCLUDING REMARKS BY THE IFSB

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*Takāful* forms an essential component of Islamic finance and provides an alternative to conventional insurance. It provides consumers, corporations and financial institutions with Sharī'ah-compliant coverage by way of risk sharing (among policyholders), rather than risk transfer. In addition to providing a Sharī'ah-compliant alternative to insurance, *takāful* promises a fair and more inclusive financial environment that contributes to a healthy economic system as well as social stability.

Notwithstanding the current development of the industry, *takāful* is still the smallest segment of the Islamic financial services industry. In 2014, the global growth rate of gross contributions in the *takāful* sector reached USD 22.1 billion, as compared to the 2006 figure of only around USD 5 billion. GCC countries, followed by Iran, and East Asia and Pacific Region (EPAC), constitute the largest share of *takāful*, and together comprise the bulk of the contributions globally. To date, Africa, South Asia and Levant still have a very small share in the total contributions. As *takāful*'s share of the insurance sector is only 1%, there is a long way to go for the *takāful* sector. Indeed, the low penetration rates in a set of countries in which the *takāful* industry operates, which is only 1.8%, indicate an untapped market for the *takāful* sector. Due to the fact that many of the target markets of the *takāful* sector – such as Turkey, Saudi Arabia, Pakistan, Qatar and Egypt – have a growing middle-class and young populations with solid growth prospects, there is room for much higher penetration rates via *takāful*.

Although growth in the global *takāful* contribution is forecasted to increase for year 2016/17, issues surrounding the industry consistently evolve along with the dynamic changes in the business environment. This calls for the need for the industry to be carefully supervised by regulatory and supervisory authorities. The IFSB has thus far focused on addressing the issues pertaining to corporate governance and financial and prudential regulation. With the issuance of a series of standards such as IFSB-8, IFSB-11, IFSB-14 and IFSB-18 in 2009, 2010, 2013 and 2016, respectively, the IFSB has provided guidance on key issues involving the areas of governance, solvency and risk management in *takāful* and *retakāful* undertakings. Moving forward, several new initiatives on *takāful* have been charted over the next few years to ensure that the current and evolving issues are taken into consideration in the new standards and guiding principles for the industry. Some of the areas to be covered include the supervisory review process of *takāful* / *retakāful* undertakings, disclosure to promote transparency and market discipline, issues arising from changes in *takāful* capital requirements, and consumer protection in *takāful*. In view of the ongoing work by the International Association of Insurance Supervisors (IAIS) to develop risk-based global Insurance Capital Standard (ICS), the IFSB has also included a work programme to reflect these changes in an updated standard on solvency in the next few years.

Apart from its standard setting and research work, the IFSB continues to promote awareness building in the *takāful* sector through conferences and seminars. In past years, many IFSB awareness programmes have specifically incorporated various sessions on the *takāful* sector. Similarly, its Facilitating the Implementation of the Standards (FIS) workshops in IFSB member countries have greatly deepened understanding of supervisory issues in the *takāful* sector and helped to increase implementation of the standards.

The IFSB is cognisant that the growth prospects for *takāful* operators vary significantly across markets and sectors, depending on the market's economic maturity, the industry's level of development, and the regulatory structure. Furthermore, the *takāful* industry will continue to struggle in the medium term due to the strong competition from the conventional insurance industry. The *takāful* industry is also faced with the challenge of harmonising the Solvency II directives with the existing regulatory framework and the variations in the *takāful* models. With the current development of the IAIS in forming a standardised Insurance Capital Standard (ICS) for all the global systemically important insurers (G-SIIs) by the end of 2019, *takāful* and *retakāful* operators may already be gearing up for the new solvency, accounting and regulatory reforms, and their implications for their business models, profitability and growth opportunities. Most *takāful* undertakings are also struggling with rigidities in the local market conditions and difficulties in offering customer-friendly products that are differentiated from conventional insurance.

In line with the mandate of the IFSB in promoting the development of the Islamic financial services industry in and among its members, this publication hopes to provide industry stakeholders with various perspectives on the *takāful* industry, including the challenges, initiatives and experiences faced by both the mature and developing markets. Some of the challenges faced by the current *takāful* operators include investing heavily in Islamic financial market instruments where any volatility directly affects their returns. These interconnections across different sectors present the need for consistent development across all other sectors to ensure healthy progress for cross-sectoral transactions. Another factor requiring attention is the *retakāful* operations where shortage and competitiveness of the *retakāful* coverage could trigger leakage to the conventional reinsurance market, causing constraints on the growth of *retakāful*. With the Global Financial Crisis looming in the background of the insurance and *takāful* industry, the market is left with no choice but to face a strengthened regulatory framework.

The IFSB continues to facilitate the development of a sound, resilient and stable Islamic financial services industry through the annual issuance of its Stability Report. The report tracks, collates and analyses key performance indicators and risk metrics for various sectors in Islamic finance. Similarly, the report delves into the issues faced by the various stakeholders in the industry due to structural and market-related developments. Importantly,

the report also tracks the latest developments by the global standard-setting organisations such as the BCBS, IAIS, IOSCO, and so on, and analyses the potential impact on the players in the Islamic financial services industry.

**Jaseem Ahmed**  
**Secretary General, IFSB**  
**April 2017**



## CONCLUDING REMARKS BY THE WORLD BANK

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We hope that this publication ignites a healthy discussion on the challenges faced by *Takāful* industry. Although, several challenges have been highlighted by esteemed authors, select challenges are worthy of immediate attention by policy makers.

Insurance is one of the essential financial services for both the household and business sectors in contemporary economies that are subject to various types of risks. Access to insurance services is especially important for poor households, which are vulnerable to negative shocks and need protection against uncertainty. Without access to good formal insurance services, the poor depend on less-reliable and often far more expensive informal-sector mechanisms. In addition, select groups of people may voluntarily exclude themselves due to non-availability of insurance services compatible with their religious beliefs.

Insurance products and services complying with the tenets of Islam, known as *takāful*, are emerging as an important component of the Sharī'ah-compliant family of financial services, helping to meet insurance needs in ways that are consistent with the local norms and beliefs of many majority Islamic countries. Providing *takāful* services to all segments of the population becomes a vital tool for financial inclusion, for mitigating risks and for enhancing economic lives. The current penetration level of *takāful* in OIC member countries is very small. While these current low levels of penetration and future needs show significant growth prospects for the *takāful* sector, some factors will determine the potential and the levels that the industry will be able to reach.

First, sound growth of a *takāful* industry and protection of stakeholders' rights require a supportive legal and regulatory regime. In the absence of an enabling regulatory framework for *takāful*, regulators often treat *takāful* operators similarly to insurance companies that assume risk transfer with guaranteed benefits. This also leads to capital and solvency requirements that are applicable to both *takāful* and insurance. On the other side, inadequate regulation can have a significant impact on the ability of *takāful* companies to function effectively and sustainably, and to supply the *takāful* products that individuals and businesses wish to purchase.

Regulators should seriously consider developing or adopting the regulatory framework in the form of prudential regulations related to conduct of business and safety and soundness of *takāful* institutions and providing safety net arrangements. They should also build other regulatory functions, including a sound governance and risk management framework, information and disclosure requirements, ongoing oversight and supervision, and liquidity

assistance for systemic stability. There is a need for countries to adopt the IFSB standards on *takāful* which provide a harmonised regulatory framework. Introduction of regulations that consider the special features of *takāful* will bring about confidence in the sector among the stakeholders and help promote the future growth of the sector, particularly for organisations that are engaged in cross-border business. To enable the implementation of the standards would also require enhancing the capacity of regulators to develop an appropriate legal and regulatory framework that suits their *takāful* models.

Strengthening the corporate governance is another essential factor in the long-run sustainability of the *takāful* sector. Regulators should provide a framework for corporate and Sharī'ah governance that, among other issues, clearly defines the roles and responsibilities of the board of directors, the Sharī'ah board and the actuaries. In order to deal with Sharī'ah-related issues and to eliminate Sharī'ah compliance risks, regulators may consider setting up unified Sharī'ah boards for all sectors of the Islamic finance industry. To avoid confusion and remove the barriers, consensus is needed among Sharī'ah scholars in each country as to how *takāful* should be implemented.

Developing alternative *takāful* models is also an important factor in the system reaching its potential. Exploring models of *takāful* that are truly cooperative in nature would diversify the organisational formats that the *takāful* industry can offer as can be found in the conventional insurance industry, which has both commercial and cooperative models. This will require not only discussing the appropriate conceptual Sharī'ah-compliant cooperative models, but also coming up with operational models of cooperative *takāful* that can be implemented in practice. Since the majority of Muslims live in low-income or lower-middle-income countries where the incidence of poverty is high, policymakers, as in other areas of the economy and finance, should consider the cost element when introducing insurance products to the low-income segment of society in order to make such products affordable taking account of the harsh realities of their life.

It is also crucial to introduce diverse delivery channels of *takāful* services in order to improve the industry and to serve poor people. Commercially viable models for *retakāful* services are needed to protect the industry from large, impactful, negative shocks. Given the social orientation of Islamic finance, the *microtakāful* segment can be integrated with mainstream *takāful*. As the hybrid commercial-cooperative *takāful* industry is not providing services to this market segment for economic reasons, alternative models that have social goals need to be developed.

While the *takāful* industry needs to expand to increase the current penetration of different types of *takāful* products such as *microtakāful* and health, the evolution of a dynamic globalised economy in the future will introduce newer types of risks and increase the demand



for insurance and *takāful* services. There are also some new areas in which *takāful* protection may be needed, including longevity and intergenerational risks, environmental and climate change risks, and cyber risks. In this regard, *takāful* can provide an ethical alternative and capture a large share of the market by coming up with risk-sharing alternatives that provide value for all segments of the population, including the poor.

In order to provide a valuable product to policyholders, *takāful* operators need to have access to suitable Sharī'ah-compliant asset classes in which to invest their premiums. The approach to developing *takāful* should also consider the level of sophistication/development of the insurance market in a particular country. However, the lack of diversified Sharī'ah-compliant assets in which *takāful* companies can invest their funds puts them at a relative disadvantage compared to their conventional counterparts and affects their investment strategies. Considering the need for long-term financing, development of the Islamic capital markets is seen as complementary to the development of the *takāful* sector.

Raising awareness and financial literacy among consumers remains a major challenge for the *takāful* industry. Consumers in Muslim countries lack awareness of *takāful* models, which can lead to a perception that these models are no different from their conventional counterparts. In order to create awareness and compete with conventional insurance companies, *takāful* operators should focus on product innovations that are simple to understand, transparent and inspire trust by religiously sensitive consumers.

Last, but not least, the lack of qualified Sharī'ah scholars and human resources who understand the unique features of *takāful* is also a major challenge for the industry. Most *takāful* operators hire staff with a conventional insurance background who may lack knowledge of the features of *takāful* operations and the expectations of clients. Therefore, training personnel to equip them with the right skills and knowledge will be another important element in the future development of the *takāful* industry.

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