

Market Review  
April 13, 2015

## Takaful Operators Struggle with Growth and Profitability

**“The opportunity presented by a potentially large global takaful market is balanced by the challenge of achieving profitability and generating policyholder surpluses.”**

While the concept of Shari’a compliant insurance has existed for several decades, it has gained momentum significantly in the past 10 years. Takaful companies have emerged in most Middle East markets all seeking to take advantage of this niche and potentially profitable segment. With the exception of Saudi Arabia (where all insurers operate under the unified co-operative insurance model which is distinctly different from the traditional takaful model), the remaining Middle Eastern takaful operators have struggled to establish competitive positions in their respective markets. This contrasts with the relative success of Shari’a compliant banking, which has established a strong presence in the Middle East. This report reviews some of the key challenges facing takaful companies in the Middle East -- their growth prospects, financial performance compared to conventional market participants and balance sheet strength.

### Growth Prospects Remain Challenging for Takaful Operators

The global takaful sector has experienced significant growth in gross written contributions (GWC) over the past decade, with GWC expected to reach USD 20 billion by 2017. The vast majority of contributions are expected to continue to originate from Malaysia and Saudi Arabia, which are considered the two key takaful markets, with the United Arab Emirates (UAE) also becoming an important growth market. The appetite for takaful remains limited in other Middle Eastern countries.

In the context of global insurance markets, overall premium volumes in many Middle East countries remain small (below USD 2 billion). This is in part related to the immature insurance sector, where penetration rates (measured by premium volume relative to gross domestic product (GDP)) are seen to be the lowest among emerging economies, but also due to the low population size (such as Qatar, Kuwait and Bahrain) and smaller economies (including Jordan and Lebanon) (see **Exhibit 1**).

Despite the rapid growth of takaful globally, it has struggled to gain traction within Middle East markets as evidenced by the ratio of takaful contributions to overall insurance business (takaful penetration) (see **Exhibit 1**). In contrast, Malaysia has achieved a credible takaful penetration of approximately 50%. With the exception of Saudi Arabia, the UAE has the largest takaful market (in terms of gross contributions) in the Middle East, with four out of the top five direct takaful companies based in the UAE. However, Bahrain has the highest level of takaful penetration, which has been aided by the development of a strong regulatory environment. This has encouraged a number of large international reinsurers (namely Hannover Re and Asia Capital Re) to establish retakaful operations in Bahrain.

A.M. Best considers the Middle East insurance markets to be concentrated. Generally, a few large players dominate their respective markets, with the other market participants competing for the remaining premium. For example, in the UAE there are over sixty insurers operating in the market with the top five companies accounting for 38% of gross premium written. Similarly, in Kuwait, the top five insurers control approximately 59% of business written. These large insurers tend to be well established with strong brand recognition and have been able to create strong franchises. The smaller, less established market participants are left to

#### Analytical Contacts:

Salman Siddiqui, London  
+44 (0) 207397 0331  
Salman.Siddiqui@ambest.com

Michael Dunckley, London  
+44 (0) 207397 0321  
Michael.Dunckley@ambest.com

#### Editorial Management:

Richard Hayes  
Ken Johnson



compete between themselves for the remaining premium as they seek to establish competitive positions in their markets.

A.M. Best has noted that takaful operators generally fall into the latter group, where emphasis is placed on growth over profitability. This often leads to intense levels of competition, with takaful companies competing directly with conventional insurers. Given their relatively new status and position in these markets, takaful operators often lack sufficient size to achieve economies of scale. The weaker cost efficiency and the start-up nature of many takaful operators results in high cost bases and expense ratios which dampen operating performance.

## Exhibit 1

### Select Middle East Countries - Key Facts (2013)

Country	Population (Millions)	Gross Domestic Product (USD Billions)	Total Gross Written Premiums (USD Millions)	Insurance Penetration	Number of Takaful/ Retakaful Companies (2014)	Gross Written Contributions 2013 (USD Million)	Takaful Penetration of Insurance Market
Bahrain	1.2	33.0	688	2.1%	6	101	15%
Kuwait	2.9	195.0	952	0.5%	11	132	14%
Oman	2.9	83.0	947	1.1%	1	47	5%
Qatar	2.1	211.0	1471	0.7%	5	194	13%
United Arab Emirates	9.1	396.0	7959	2.0%	13	649	8%
Jordan	6.6	34.0	686	2.0%	2	62	9%
Egypt	82.1	272.0	1851	0.7%	8	63	3%

Sources: Swiss Re sigma No. 3/2014; MENA Insurance Directory 2015, A.M. Best research.

Due to the smaller size of the above mentioned markets and their fragmented nature, an obvious opportunity for takaful firms to strengthen their profiles and improve the diversification of their earnings would be to expand regionally into neighbouring countries. However, thus far all direct takaful writers in the region remain single country (and at times single city) operators, which is broadly in line with their conventional counterparts. A.M. Best has observed that a particular challenge for takaful companies seeking to expand regionally is the need to meet vastly different regulatory environments. The lack of uniformity in takaful accounting practices and regulation increases compliance costs and thereby dampens the desire for regional expansion. Whilst some efforts have been undertaken by bodies such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Standards Board (IFSB) to standardise takaful operations globally, further impetus is required from local regulators to harmonise and improve the regulatory environment in the region.

The competitive pricing environment means that some takaful operators find themselves engaged in price wars, which can lead to accepting business significantly below their technical price, adversely impacting underwriting profitability. This is further compounded by takaful products being sold primarily through broker and agency distribution channels. In the UAE for example, 85% of takaful products are sold via these channels, which makes price the key purchase consideration for customers. This contrasts with Malaysia where Bancatakaful is a key distribution channel. Bancatakaful allows takaful companies to tap into the existing customer bases of Islamic banks, which have already shown a willingness to buy Shari'a compliant financial products.

A further factor is the inability of takaful operators to differentiate themselves from conventional insurers. Islamic banking in the Middle East has been relatively more successful than takaful, creating awareness and establishing brands that differentiate themselves from

conventional banks. Due to this, they have been adept at selling their Shari'a compliant products at higher price points than conventional banks.

Whilst takaful operators have tried to replicate these efforts, they have not yet achieved the same level of success. Their marketing has highlighted their Unique Selling Points (USPs) of being Shari'a compliant in predominantly Muslim countries as well as their mutuality models which should benefit policyholders in periods of good profitability. In theory, this should have led to customers being willing to pay higher rates for takaful products (as they would be able to get a discount at renewal or cash distribution from surpluses in later years). However, these efforts are often undone by practical realities where very few takaful companies are making surplus distributions or are providing discounts to policyholders. This is a result of takaful companies in the region running deficits in their policyholders' funds caused by poor underwriting performance and excessive wakala fees (see "Financial Performance Lags behind Conventional Players").

Those companies that generate surpluses often seek to retain them to support prospective insurance risks and to strengthen the balance sheet against unforeseen issues that may arise, such as adverse reserve development. The lack of realisation of promised benefits causes many takaful companies to lose their distinguishing attributes in the eyes of the customer and forces them to compete on price with conventional insurers.

Whilst efforts in pricing and promotion have been mixed, takaful companies have also struggled with the design of their products. For many years, takaful companies have hoped for the family/life takaful market to take off and have developed products designed to meet this expected demand. This follows the Malaysian and Indonesian experience where family takaful is sought after and remains profitable for operators. However, the expected windfall from this business line has failed to materialise in the Middle East, resulting in takaful companies incurring costs to develop and obtain regulatory approval for products that have ultimately lacked demand. Overall, the life insurance market remains small in the Middle East as customers fail to see a necessity for life insurance products due both to the generous social security schemes and limited awareness and knowledge of saving and protection products. For family takaful to develop into major revenue streams, operators will need to increase their efforts to bring about a heightened awareness for their products and the associated long-term benefits.

At the same time, the infatuation with waiting for the demand for family takaful business to expand has meant that takaful operators have neglected to innovate and introduce other products that could reach untapped markets. For example, microtakaful products have been launched successfully in countries such as Indonesia, Pakistan and Sudan. These are often sold in conjunction with microfinance products, and provide cover in a number of areas, such as defaulting on loan repayments, physical disability and loss of income. There is potential for microtakaful products to be marketed in Middle Eastern countries that have greater levels of income inequality (such as Egypt and Jordan), however, they are unlikely to be as successful in richer countries such as Qatar and the UAE. Thus far, few takaful operators in these countries have shown an interest in microtakaful products or to differentiate their product offerings against the conventional companies.

### Financial Performance Lags behind Conventional Players

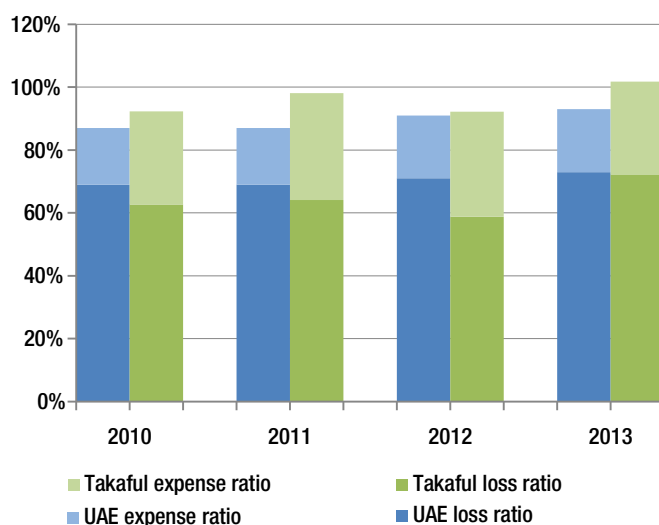
In A.M. Best's recent analysis of 14 Gulf Cooperation Council (GCC) takaful operators and 24 UAE conventional insurers, the takaful companies have underperformed compared to their conventional counterparts over the past four years (see **Exhibit 2**). The two groups demonstrate a similar level of claims experience with the group of takaful companies

even producing stronger claims ratios in most years. However, the difference in operating performance becomes more apparent once expense ratios are considered. The takaful companies had a weighted average expense ratio of 30% in 2013 compared to 20% for the UAE conventional insurance market. The key reason for this is size -- takaful companies often have smaller franchises due to being more recently founded. As a result, they lack the economies of scale necessary to cover fixed costs and lower their expense ratios. In the GCC markets, additional pressure is placed on staff costs by the limited pool of experienced insurance professionals. Additionally, localisation initiatives put in place by several jurisdictions force companies into expensive competition with the public sector for national workers. Furthermore, as regulators increase their level of oversight, compliance expenses will increase disproportionately for smaller players, exacerbating the lack of cost efficiencies.

The effect of this higher expense burden is that takaful companies must produce better loss ratios than conventional insurers to achieve a similar level of underwriting profitability. As previously noted this is difficult to achieve given that takaful operators compete directly with

the conventional market for the same business and often through the same distribution channels.

## Exhibit 2 Underwriting Performance of GCC Takaful Companies Compared to the UAE Insurance Market



Based on a sample of 14 GCC primary Takaful companies, 24 UAE conventional companies  
Wakala fees have been substituted for actual management expenses to derive 'true' expense ratios for the insurance portfolios  
Source: A.M. Best research

So how can financial performance be improved for takaful companies? A.M. Best believes that one option is to achieve greater scale, writing more business and earning greater marginal profits to cover fixed costs. This option would require takaful companies to adopt high growth strategies which in already competitive markets would encourage operators to under-price products, resulting in potentially weaker underwriting performance. Instead of concentrating on price, companies can attempt to grow through improved distribution, perhaps by leveraging their unique offering and seeking

bancassurance arrangements with Islamic banks. Takaful companies might also create scale through consolidation with other takaful providers, achieving cost synergies through combining functions.

Another solution to improving underwriting performance would be to develop a niche through differentiation. Takaful companies may be able to effectively market the ethical differences in their products and the spirit of mutuality in order to cater to a specific consumer base. Where companies can offer surplus distribution, this can further differentiate them from conventional insurers, both by proving a financial incentive to customers and demonstrating the 'sharing' benefit of mutuality. Additionally, companies can seek to compete on service

levels and claims management rather than price. This strategy could lessen the competitive and pricing pressure on takaful companies, allowing them to achieve stronger profitability despite their smaller scale.

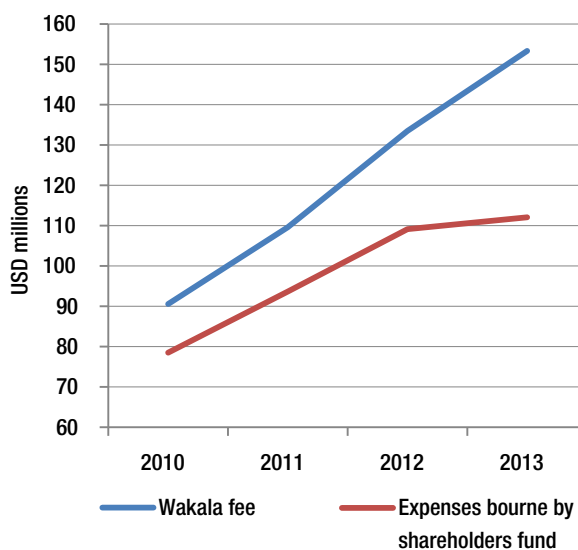
If takaful companies expect to distribute surpluses to policyholders as well as dividends to shareholders, the need to produce strong and stable earnings is in fact more important than the conventional sector. An interruption in surplus distribution might damage the goodwill already created, potentially obliging management to continue with distributions even when it reduces the level of policyholders' surplus. As with many young companies, achieving profitability takes time and takaful operators' special status in the eyes of some consumers may allow them to perform better over the long term.

### Balance Sheets remain Unbalanced

Policyholder security depends on having sufficient liquidity to pay claims -- either from independent capitalisation of the policyholders' fund or from the interest-free loan from shareholders. A.M. Best adopts a two-stage approach to the analysis of the risk-adjusted capitalisation of takaful companies. Risk-adjusted capitalisation is measured for the company as a whole, taking into account the balance sheets and operating activities of both funds, and again for the policyholders' fund on a standalone basis. In order to be considered for a secure rating, a takaful company must either have an adequate level of capitalisation on both a consolidated basis and within its policyholders' fund, or be adequately capitalised overall as well as existing in a sufficiently strong regulatory environment. In order to meet this criterion, the regulator must ensure policyholder protection by guaranteeing the permanence of the Qard' Hassan, (the interest-free loan provided by shareholders to cover any deficit in the policyholders' fund).

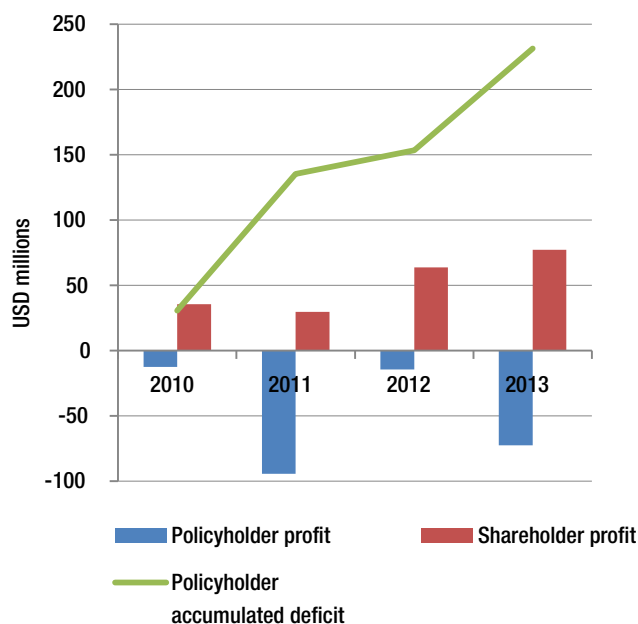
Takaful companies can adopt several different models to reflect the ethical requirements of Shari'a. In each model, the policyholders' fund reflects the revenue and claims costs of the takaful business and the shareholders' fund charges fees to the policyholders' fund. Under the wakala and hybrid models, used by most GCC takaful companies, wakala fees are designed to cover the expenses incurred by the shareholders in management of the policyholders' fund, and to provide a reasonable margin for profit to cover the operator's cost of capital. The level of wakala fee is typically set annually by management as a percentage of GWC and in consultation with the Shari'a board of each takaful company. Adjusting the fee is the key method in allocating profit between the two funds. As shown in **Exhibit 3**, the wakala margin (difference between the wakala fee charged and actual management expenses incurred) has been increasing between 2010 and 2013, effectively increasing the level of profit transferred from policyholders' funds to the shareholders' funds.

**Exhibit 3**  
**Margin of Wakala Fee over Expenses Borne by Shareholders**



Based on a sample of 18 GCC re/takaful companies  
Source: A.M. Best research

### Exhibit 4 Uneven Distribution of Profit, Growing Deficits



Based on a sample of 18 GCC re/takaful companies  
Source: A.M. Best research

The level of surplus that can be generated in the policyholders' fund depends on the underwriting and investment profit that the company can produce, subject to the level of fees levied to the policyholders' fund by the shareholders. As wakala fees have increased, it has become harder for policyholders' funds to generate sufficient profit to both pay the wakala fees and retain a sufficient underwriting profit to grow their surplus.

As shown in **Exhibit 4**, for the group of 18 (re)takaful companies analysed, there is an uneven distribution of profit between the policyholders' and shareholders' funds. Whilst policyholders have suffered

due to poor underwriting, large wakala fees have added to the weak technical performance. In fact, for the aggregated group of companies, in each year, shareholders' funds have achieved a profit whereas policyholders' funds have shown an annual deficit.

Continued annual deficits in policyholders' funds are increasing the level of accumulated deficit and therefore weakening the financial strength of the policyholders' funds. During 2013, the accumulated deficit for these companies increased by 51%. A.M. Best notes that this is not the case with all takaful companies, indeed a number of operators have achieved good technical performance as well maintaining a good balance of earnings between the two funds.

In order for the takaful model to perform effectively for its members, the policyholders' fund must be able to operate profitably and develop sufficient surplus in order to start making distributions. Increasing policyholders' fund deficits impair both the strength of the claims-paying ability of takaful funds and make the prospect of future distributions less likely. Only a few takaful companies in the GCC have distributed surpluses to policyholders; this is because most companies do not have a history of producing policyholder annual surpluses in order to build up an accumulated surplus from which to make distributions. Given the trend of growing deficits in policyholders' funds shown above, it is unlikely that many takaful companies will be able to make distributions over the medium term.

Uneven distribution of profit between policyholders and shareholders could be attributed to inadequate incentive structures and governance. Wakala fees are charged as a percentage of gross contributions, incentivising shareholders and operators of companies to concentrate on top-line growth to maximise fee income, rather than profitability which can improve policyholder surplus generation. Unlike other mutual companies, takaful companies do not have policyholder representation on their boards of directors. Instead, these are made of shareholders and independent professionals. Therefore, there is less pressure on management to act in the interest of participants.



The uneven profitability of the two funds may also contradict the spirit of mutuality of takaful companies. Takaful companies are designed to be operated for the benefit of the members of the fund, whilst allowing the shareholders who operate the fund to make a reasonable profit in return for management. Instead, with growing policyholder deficits and increased reliance of policyholder funds on Qard' Hassan, these results indicate that shareholders are benefitting to the detriment of fund members.

### Concluding Thoughts

Taking into account the huge global Muslim population, A.M. Best believes that there are significant opportunities for takaful operators to provide sound financial protection that is in line with consumers' religious sensibilities. However, there are a number of challenges for the industry to overcome.

Due to a lack of sufficient differentiation, takaful providers remain subject to fierce price competition with larger, more established insurers that already benefit from greater brand awareness and established distribution networks. The next challenge for the takaful market will be to achieve growth without further compromising on profitability by demonstrating the individuality of their offering and developing a niche market position and a loyal customer base.

When an improved level of profitability is achieved, it is important that companies achieve a balance of earnings between policyholders and shareholders. Shareholders require dividends to justify their capital investment, but policyholders also have the right to a share of the surplus accruing from the good management of the takaful fund. Retention of surpluses in policyholders' funds will improve mutuality in line with the takaful model, as well as the level of policyholder protection. This alignment of policyholder and shareholder interests will also help operators differentiate themselves from conventional insurers.

Developments in regulation are also key for policyholder protection. Takaful companies will do well to lobby for more robust, comprehensive and consistent rules in order to improve confidence in the industry and create the right environment for growth. This is particularly important in countries where the regulatory code does not yet deal specifically with takaful.

In conclusion, A.M. Best believes that the better the industry tackles these challenges, the better it will be placed to serve the needs of the enormous potential market for Shari'a compliant insurance, to the benefit of all stakeholders.

### Exhibit 5

#### A.M. Best Ratings for Takaful Operators in the Middle East

All ratings as of March 26, 2015

AMB #	Company Name	Country	Current ICR	Current ICR Outlook	Rating Effective Date	GWP 2013 (USD Thousands)
90059	ACR Retakaful MEA	Bahrain	a-	Stable	12/19/2014	21,537
91840	Solidarity General Takaful	Bahrain	bbb	Stable	6/20/2014	34,681
90708	Abu Dhabi National Takaful Company	United Arab Emirates	bbb+	Stable	8/21/2014	73,999
92651	National Takaful Company (Watania)	United Arab Emirates	bbb-	Stable	3/19/2015	35,150
93190	Emirates Retakaful Limited	United Arab Emirates	bbb+	Stable	12/4/2014	67,105
91584	First Insurance Company	Jordan	bbb	Stable	1/21/2015	32,928
78631	Qatar Islamic Insurance Company	Qatar	bbb+	Stable	1/20/2015	58,349

Source: Statement file global

Published by A.M. Best Company  
**Special Report**

CHAIRMAN & PRESIDENT **Arthur Snyder III**  
 EXECUTIVE VICE PRESIDENT **Larry G. Mayewski**  
 EXECUTIVE VICE PRESIDENT **Paul C. Tinnirello**  
 SENIOR VICE PRESIDENTS **Douglas A. Collett, Karen B. Heine,**  
**Matthew C. Mosher, Rita L. Tedesco**

**A.M. BEST COMPANY**  
**WORLD HEADQUARTERS**  
 Ambest Road, Oldwick, NJ 08858  
 Phone: +1 (908) 439-2200

**WASHINGTON OFFICE**  
 830 National Press Building  
 529 14th Street N.W., Washington, DC 20045  
 Phone: +1 (202) 347-3090

**A.M. BEST AMÉRICA LATINA, S.A. de C.V.**  
 Paseo de la Reforma 412  
 Piso 23  
 Mexico City, Mexico  
 Phone: +52-55-5208-1264

**A.M. BEST EUROPE RATING SERVICES LTD.**  
**A.M. BEST EUROPE INFORMATION SERVICES LTD.**  
 12 Arthur Street, 6th Floor, London, UK EC4R 9AB  
 Phone: +44 (0)20 7626-6264

**A.M. BEST ASIA-PACIFIC LTD.**  
 Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong  
 Phone: +852 2827-3400

**A.M. BEST ASIA-PACIFIC (SINGAPORE) PTE. LTD.**  
 6 Battery Road, #40-02B, Singapore  
 Phone: +65 6589 8400

**DUBAI OFFICE\* (MENA, SOUTH & CENTRAL ASIA)**  
 Office 102, Tower 2  
 Currency House, DIFC  
 PO Box 506617, Dubai, UAE  
 Phone: +971 43 752 780

\*Regulated by the DFSA as a Representative Office



**A Best's Financial Strength Rating** is an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. It is based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile. The Financial Strength Rating opinion addresses the relative ability of an insurer to meet its ongoing insurance policy and contract obligations. These ratings are not a warranty of an insurer's current or future ability to meet contractual obligations. The rating is not assigned to specific insurance policies or contracts and does not address any other risk, including, but not limited to, an insurer's claims-payment policies or procedures; the ability of the insurer to dispute or deny claims payment on grounds of misrepresentation or fraud; or any specific liability contractually borne by the policy or contract holder. A Financial Strength Rating is not a recommendation to purchase, hold or terminate any insurance policy, contract or any other financial obligation issued by an insurer, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser.

**A Best's Debt/Issuer Credit Rating** is an opinion regarding the relative future credit risk of an entity, a credit commitment or a debt or debt-like security. It is based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile and, where appropriate, the specific nature and details of a rated debt security. Credit risk is the risk that an entity may not meet its contractual, financial obligations as they come due. These credit ratings do not address any other risk, including but not limited to liquidity risk, market value risk or price volatility of rated securities. The rating is not a recommendation to buy, sell or hold any securities, insurance policies, contracts or any other financial obligations, nor does it address the suitability of any particular financial obligation for a specific purpose or purchaser.

Any and all ratings, opinions and information contained herein are provided "as is," without any expressed or implied warranty. A rating may be changed, suspended or withdrawn at any time for any reason at the sole discretion of A.M. Best.

In arriving at a rating decision, A.M. Best relies on third-party audited financial data and/or other information provided to it. While this information is believed to be reliable, A.M. Best does not independently verify the accuracy or reliability of the information.

A.M. Best does not offer consulting or advisory services. A.M. Best is not an Investment Adviser and does not offer investment advice of any kind, nor does the company or its Rating Analysts offer any form of structuring or financial advice. A.M. Best does not sell securities. A.M. Best is compensated for its interactive rating services. These rating fees can vary from US\$ 5,000 to US\$ 500,000. In addition, A.M. Best may receive compensation from rated entities for non-rating related services or products offered.

A.M. Best's Special Reports and any associated spreadsheet data are available, free of charge, to all *Best's Insurance News & Analysis* subscribers. Nonsubscribers can purchase the full report and spreadsheet data. Special Reports are available through our Web site at [www.ambest.com/research](http://www.ambest.com/research) or by calling Customer Service at (908) 439-2200, ext. 5742. Briefings and some Special Reports are offered to the general public at no cost.

For press inquiries or to contact the authors, please contact James Peavy at (908) 439-2200, ext. 5644.

**SR-2015-400**