Takaful and Mutual Insurance

Alternative Approaches to Managing Risks

Book Launch
November 13, 2012
Chapter 1: Introduction

The joint stock model, mutual or cooperative model have been the traditional ways of delivering insurance.

Some critical differences separate takaful from conventional insurance

Religion is not a prerequisite for participation

Malaysia is a leading regulator of takaful

Bahrain’s regulatory framework sets out explicitly the need to use the wakala model for underwriting and the mudharaba model for investment returns

Countries such as Singapore and UK have no takaful specific regulation, but host takaful entities

The lack of specific regulation makes the development of Takaful more difficult
Chapter 2: The Primary Insurance Models:

- Alternatives to Risk Management
  - risk sharing
  - risk transfer
- Covers the principle differences between stock companies and Mutuals from the perspective of
  - ownership
  - risk mitigation basis
  - alignment of various stakeholders interest
  - cost of covers
Chapter 2: The Primary Insurance Models

- Insurance is primarily about managing contingent risk, but it also has implications on investment strategy and influences the capital markets.
  - makes ‘bonds’ cheaper or more expensive.
  - attaches a premium for certain equity investments.
- Touches on the question whether takaful is actually mutual, from a;
  - risk management perspective.
  - who owns equity on the operation.
- Looks at the role of Sharia in takaful
  - in how it is structured.
  - its influence on the choice of investments that the operation makes.
- Concludes that takaful is not only for Muslims rather it an alternative way of managing risks. Takaful puts priority on:
  - product transparency.
  - social responsibility when investing funds.
Chapter 3: Overview of Mutual Structures

- Cooperative and Mutual Insurance has stood the test of time and have grown whilst still maintaining its principles and practices.
- Takaful can leverage their mutuality to improve penetration into Muslim and Non-Muslim communities.
- Takaful need to demonstrate what makes them difference from the commercial providers, what makes them Shariah compliant.
- Community based projects, CSR, risk prevention, education strategies can have an impact on policyholder loyalty and acceptance.
- Involvement of policyholders in decision making can make a difference and provide an important channel of market information.
- A more ethical, transparent and client centred approach can also increase the commitment and motivation of staff.
- Takaful management and Takaful board need to understand their responsibilities as Takaful operators.
- Takaful shareholders need to understand a value based approach will provide more sustainable profits in the long term.
Takaful and Mutual Insurance
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Takaful shareholders need to understand a value based approach will provide more sustainable profits in the long term.

Collaboration and sharing of experiences between providers and associations can facilitate stronger unity.

Focus should be on commonalities rather than differences

Standards, parameters, performance indicators have to be created by the industry to enable identification of “good” Takafuls and “not so good” Takafuls.

The industry needs a strong representative body which behaves in the interest of the movement as whole and takes responsibility for its development.

Regulators, development agencies and donors need to support the establishment of a pure mutual Takaful and pure mutual microtakaful
Chapter 4: Faith-Based Risk-Sharing Structures

- Takaful is not alone, there are other religious insurance companies, especially Christian companies. We can look to them for ideas for our own development.
## Chapter 4: Faith-Based Risk-Sharing Structures

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<thead>
<tr>
<th></th>
<th>Christian Health Sharing Networks</th>
<th>Takaful</th>
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<tbody>
<tr>
<td>Guarantees in benefits</td>
<td>NO</td>
<td>YES</td>
</tr>
<tr>
<td>Regulated</td>
<td>NO</td>
<td>YES</td>
</tr>
<tr>
<td>Direct contact between participants</td>
<td>YES</td>
<td>NO</td>
</tr>
<tr>
<td>Restricted membership</td>
<td>YES</td>
<td>NO</td>
</tr>
<tr>
<td>Wide range of products / coverage</td>
<td>NO</td>
<td>YES</td>
</tr>
</tbody>
</table>
Chapter 4: Faith-Based Risk-Sharing Structures

- Ideas from Christian Associations (fraternal, friendly societies, cooperatives)
  - Use surplus to fund scholarships for members
  - Use operators size to negotiate for discounts for members
Chapter 5: Hybrid Insurance Structures: Reciprocals, Hybrid Mutual Insurers, and Takaful

- Hybrid insurance structures are operations which are neither pure stock insurance companies nor pure cooperatives, including reciprocals, hybrid mutual and takaful.

- Reciprocals are entities set up to meet the special insurance needs of certain groups. One example is the farmers insurance group. It is a management company owned by Zurich Financial Services and manages the farmers exchange. They receive fees as a percentage of premiums for managing the non-claims aspects of the farmers exchange.
Chapter 5: Hybrid Insurance Structures: Reciprocals, Hybrid Mutual Insurers, and Takaful

A discretionary mutual is a company where the board of directors has the authority to decide who is accepted for membership, the level of protection it will grant and whether and how much claims will be paid. They focus on specialized coverage that some segments of society find difficult to obtain insurance for. For example Capricorn Mutual in Australia is managed by Capricorn Mutual Management. Fees are fixed and paid monthly in addition to performance related fees and 20% of audited surplus.

*Hybrid mutuels are similar but obtain insurance coverage above a certain retention level.*
Takaful is also a hybrid structure. On the one hand we always say that takaful is similar to a cooperative. On the other hand the Takaful operator has as its goal making profit, unlike a pure cooperative where the participants are also the owners of the cooperative. To be technically precise for takaful, the takaful operator manages a risk fund, where the risk fund operates similar to a cooperative.
Chapter 6: Trade-offs in Takaful

This chapter first looks at the ‘types’ of takaful set ups in practice today

<table>
<thead>
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<th>Takaful products</th>
<th>Conventional insurance products</th>
<th>Presence of Sharia Council</th>
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</thead>
<tbody>
<tr>
<td>Standalone takaful</td>
<td>✓</td>
<td>-</td>
<td>✓</td>
</tr>
<tr>
<td>Takaful window</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Self described takaful</td>
<td>✓</td>
<td>-</td>
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</tr>
</tbody>
</table>
Chapter 6: Trade-offs in Takaful

- Takaful practices vary in several aspects of implementation
  - sharing of underwriting and/or investment surplus with the operator.
  - how fees are applied and where.
  - how products ‘look and feel’ compared with conventional insurance.
- Considers what should be role of Regulators
  - Regulations provide market discipline and protection for policyholders but also add expense and complexity.
  - Should regulations be different between Mutuals and stock companies?
  - Should regulations restrict the takaful model that can be practiced in its jurisdiction?
Chapter 6: Trade-offs in Takaful

- Consider the role of Qard (loan to participants) in takaful
  - Applies to cover cashflow deficits and/or statutory deficits in participant's risk pool.
  - Concept of a ‘Qard’ to cover a deficit is unique to jurisdictions with specific regulations for takaful. How should qard be accounted for?
Chapter 6: Trade-offs in Takaful

• The lessons for takaful from Mutuals
  - lower charges and a focus on service as compared to stock companies.
  - the need to build up retained surplus to ensure its continuing solvency.
  - less complicated products for Mutuals results in simpler liability management.
  - less guarantees means less dependence on capital
  - greater equity among policyholders.
  - cooperative culture in ensuring a sense of belonging between policyholders and the company.
  - be supportive of local communities.
Chapter 7: Principal-Agent Issues in Takaful

- The chapter discusses the various sharia compliant contracts currently used in takaful and how misalignment of stakeholders interest can arise.
- This is contrasted with similar challenges in stock insurers and Mutuals.
  - owner-manager conflicts
  - owner-policyholder conflicts
- The chapter also looks at the lack of clarity and agreement among Sharia scholars as to several important features of how takaful should be implemented. This has added to some confusion as to the conduct of takaful.
Chapter 7: Principal-Agent Issues in Takaful

• Recaps that
  - Modern Takaful is neither fully a mutual nor is it fully a stock insurer set-up. This hybrid nature has arisen mainly due to Regulatory capital requirements.
  - The natural tendency for shareholders to maximize profits and policyholder to minimize cost of cover can result in undesirable consequences.
Chapter 7: Principal-Agent Issues in Takaful

• The chapter explores this Principal-Agent conundrum in Takaful.
• Policyholders are the ‘Principal’ who hires the takaful operator as its ‘Agent’ to run the business.
• The interest of the policyholders and the shareholder can be very divergent and this raises important issues as to corporate governance.
Whereas general takaful and yearly renewable family takaful products do not rely on investment income, other family products do. These products can be either for protection or savings. Currently the most popular plan has been single contribution credit policies (MRTT) though unit linked is now very popular in Malaysia especially. Unit linked is useful to pass the investment risk to participants where Islamic investment classes are limited.
Chapter 8: Investments in Takaful

- Although takaful doesn’t have investment guarantees (yet) like conventional life insurance does, we do have benefit guarantees as well as implicit investment guarantees sometimes.

- The main investment classes used by takaful are equity, Islamic bonds, deposits and real estate. Whereas conventional life insurers depend on bonds to cover their guarantees, most countries do not have sufficient Islamic bonds.

- Islamic Bonds, called sukuk, involve obtaining partial ownership in a debt (sukuk murabaha), asset (sukuk ijarah), project (sukuk istisna’) or business (sukuk musharaka).

- Sukuk are controversial, especially in Malaysia. The president of the shariah council of AAOIF estimates that 85% of sukuk are not shariah compliant.

- Products developed by takaful operators should take into account available assets. With the lack of long term fixed assets in Takaful perhaps we should not give guarantees.
Chapter 9: Challenges for Takaful Going Forward

- Takaful is faced with a number of challenges due to its hybrid nature as well as its lack of suitable investments. There are many models for takaful being practiced even in a particular country. Each model has its own unique risk profile and particular risks.

- Risk Based Capital (RBC) is coming worldwide, including for takaful. The goal of RBC is to determine how much risk an insurer is taking on and ensuring there is enough capital to cover those risks.

- Determining these risks is difficult for any insurer, but for takaful we need to also determine who is responsible for each risk and who will pay for each risk. For instance if we say that the risk fund is owned by the participants and the operator only manages the fund, by right the RBC charges for benefits should be covered by the participants through retained capital or other means.
Similarly Islamic assets are not identical to conventional assets due to the need for ownership in Islamic assets. If RBC asset charges as identical to conventional asset charges then Takaful is being overcharged.

The determination of who is responsible for protecting participants is key for takaful, as we normally say that participants are the owners of the takaful risk fund though they have no control over this fund.

The board of directors must take responsibility for treating customers fairly. Although this can be passed on to others, the issue is that fairness can mean both technical as well as shariah issues. By right a panel should be put together comprising the actuary, a member of shariah as well as a participant advocate to ensure fairness.
Chapter 9: Challenges for Takaful Going Forward

Qard is a perpetual challenge in takaful as there could be challenges under IFRS 4 and this could provide a means for takaful operators to painlessly underprice their products.
Chapter 10: Oversight in Takaful

- The Role of takaful in a developing world

  - To address the Mortality Protection Gap (Income to maintain the survivors on the early death of the ‘breadwinner’ is approximately $10 \times$ average annual salary).
  
  - To support the development of Islamic finance (insure assets underlying sukuks).
  
  - To source long term savings for infrastructure investments.
  
  - To encourage saving for retirement so as to be less dependent on government.
Chapter 10: Oversight in Takaful

• Oversight in takaful requires a combination of
  - Supportive regulations
  - Proper pricing and reserving practices among the takaful operators.
Chapter 10: Oversight in Takaful

• Basics of regulating takaful
  - ensure adequate pricing is practiced.
  - product design should satisfy a need of the participant rather than a need of the Operator.
  - ensure availability of the appropriate sharia compliant asset classes necessary to support the products available before allowing such products to be launched.
  - ensure risks to the participant and the operator are identified before the product is launched and the operator has taken steps to manage these risks.
  - should have simple and clear contract wordings.
  - regulate marketing materials and intermediaries.
  - clear guidelines as to how surpluses and deficits shall be shared with the various stakeholders.
Chapter 10: Oversight in Takaful

• Basic of governance
  - Ensure that the takaful model used minimizes potential conflicts of interest among the various stakeholders.
  - Three important levels of governance in takaful
    - **Board of directors** are responsible to the shareholders and the regulators
    - **Sharia advisory board** is responsible for Sharia compliance. Suffers from lack of clear standards, thus requiring a ‘supreme’ sharia council to have the final say and decisions.
    - **Actuary** is responsible for technical application of takaful but the profession also need regulatory guidelines in order to do its work effectively.
• Same technical apparatus as takaful but three peculiar features that relate to its social mission:
  → changing nature of inherent risks
  → effectiveness linked, to some extent, to the use of zakat funds
  → proposition inextricably linked to the proper use of Islamic microfinance instruments

• The poor face essentially the same risks as better-off persons but manage risks after the event occurs not before the event:
  → need of cost-effective business models that understand that the poor have different needs and priorities
  → demand-driven products are a prerequisite

• Some products will be profitable, and others will not be, but the point is that, even if there is a loss, the company’s commitment to the social values embedded in microtakaful should be able to sustain it
• The benefits have to be small, but the scale must be large: as a consequence, the profit margins per unit of sale also have to be small, but the scale of the business has to allow for attractive profits for the microtakaful provider.

• Because of the scale, the estimated claims ratios and mortality rates in microtakaful are likely to be closer to the experience, and this will make it easier to estimate provisioning and profitability and reduce the margin of error.

• The implementation of microtakaful has two broad goals:
  → to secure the revolving funds of the Islamic microfinance institutions
  → to secure the payment to the IMFI in case of disability and death.
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The implementation of microtakaful has two broad goals:
» To secure the revolving funds of the Islamic microfinance institutions
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Some features:

→ only major insurable risks should be covered by a small benefit package to keep premiums affordable
→ policy language should be simple, with either no or only a few exclusions
→ group insurance policies should be used as a means to reduce administrative costs
→ group pricing should be applied, policy application and claims documentation should be reduced to a minimum, and claims should be settled quickly
→ premium amounts and payments ought to be adapted to the cash flow of the customers; the continuation in payment of premiums should be *directly or indirectly linked* to income-producing ventures
→ underwriting, investments, and reinsurance should all follow sharia prescriptions
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• Building blocks:
  » credit life with coverage for the outstanding balance
  » credit disability with coverage for the outstanding balance of the financing
  » A term life policy for clients that corresponds to the term of financing
  » Additional lives: covers a certain number of additional household members
  » Continuation: a one-month renewable term policy as a continuation of the additional benefit policy
At a later stage additional and more complex products can be added, such as:

→ (i) Saving Life with Transition Funds, Pensions, Endowments, Education Life
→ (ii) Personal Accidents and Unemployment
→ (iii) Property Insurance covering fire, theft, rainfall, floods, livestock, agriculture prices
→ (iv) Annuities and Endowment
→ (v) Health covering optical, surgical, out-patient, hospitalization, dental, dread diseases
→ (vi) Disabilities Insurance and Dismemberment Insurance
→ (vii) Integrated Insurance packages
→ (viii) Crop Loss Insurance
→ (ix) Flood, Storm damage Insurance
→ (x) Marriage.
Chapter 12: Retakaful

- **Retakaful** - Young, experimental and evolutionary

**Relative to Reinsurance**
- Function (Similar especially on the risk management aspect)
- Main difference (Sharia-compliance elements)

**Challenges** - Pre-operational (Promoters; Sharia Advocacy; Social to Capitalistic tendency)
- Operational (Model; Business Sources; Contract Terms; and Qard Hasan)
- Sustainability going forward (Critical Mass, Value Proposition, Supply Chain; Harmonization; Solution)

**Prospects** - Vital component to support the sharia-compliant chain of the global Islamic finance industry
Chapter 13: Regulatory Framework

- As a hybrid regulating takaful is different than conventional insurance
- A risk based approach is ideal, but due to a lack of technical expertise a rules based approach might be needed initially
- Allowing a conventional insurer to sell takaful (takaful windows) is generally only allowed in shariah if full takaful operations are not allowed under regulations
- We should not compete based on who is more shariah compliant. There should be a consensus in each market
Regulating takaful should be substance over form. An operator who looks and operates very similar to conventional insurance should have capital requirements similar to conventional insurance. An operator who has a distinct operation from conventional should have different capital requirements. This is the challenge.

Fairness between conventional insurance and takaful regulations should be a major goal, but this is easier said than done and requires technical expertise to ensure this.
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