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Regulating takaful – making a difference

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Presentation today

- Making sense of takaful and the insurance market
- Regulating takaful
- Moving Forward – One possible direction
- Conclusion

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Making sense of takaful and the insurance market

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Making sense of takaful – back to basics

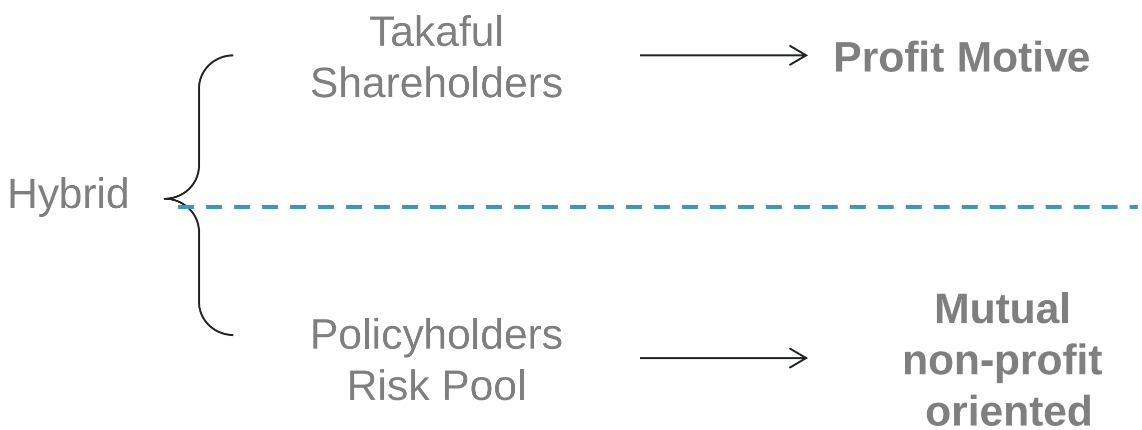
- Two basic reasons why insurance is not Sharia compliant
  - The insurance contract is a commercial contract where the insurer takes speculative risk, for profit
  - The investments of insurers includes investments which are prohibited by Sharia
- Takaful is a Mutual insurer whose basic objective is mutual assistance among members in their time of loss. Premiums paid to the takaful risk pool are treated as a <u>donation</u> and the Mutual's investments are in Sharia compliant assets.
- Policyholders of Mutuals are "members" of the Mutual. Management of the Mutual works for the members and any solvency/operating <u>capital would be provided by members</u>.

Insurance without capital – is this possible?

- Crowd funding "insurance" through social media e.g. www.youcaring.com www.gofundme.com
  - No guarantee sufficient funds are raised
  - No guarantee fund raiser is legitimate
  - Likely donations coming from friends and relatives

Modern Takaful

- Takaful as currently practiced is a hybrid:



- Shareholders will provide solvency capital and working capital to the takaful company in return for a pre-determined fee while participants pay a donation to the policyholders risk pool.

The Insurance Market
-How it works

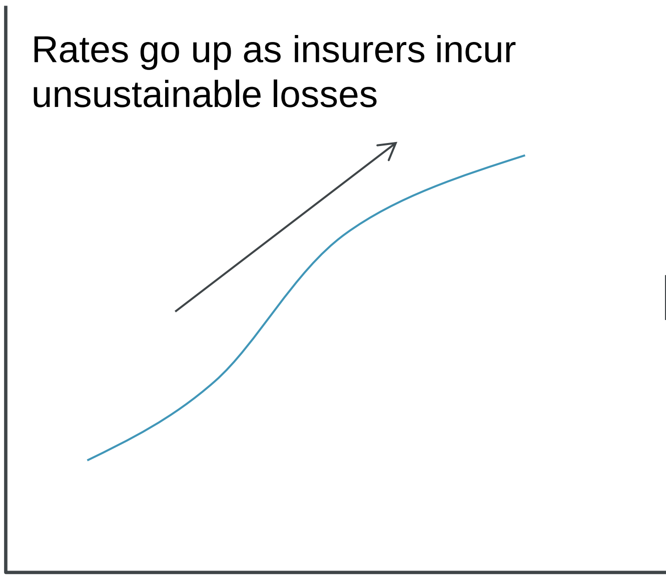
- Insurers competes for business through
  - Products
  - Service (e.g. easy and fast claims settlement)
  - Accessibility (e.g. number and spread of agents/intermediaries)
  - Level of premium rates

Different lines different priorities

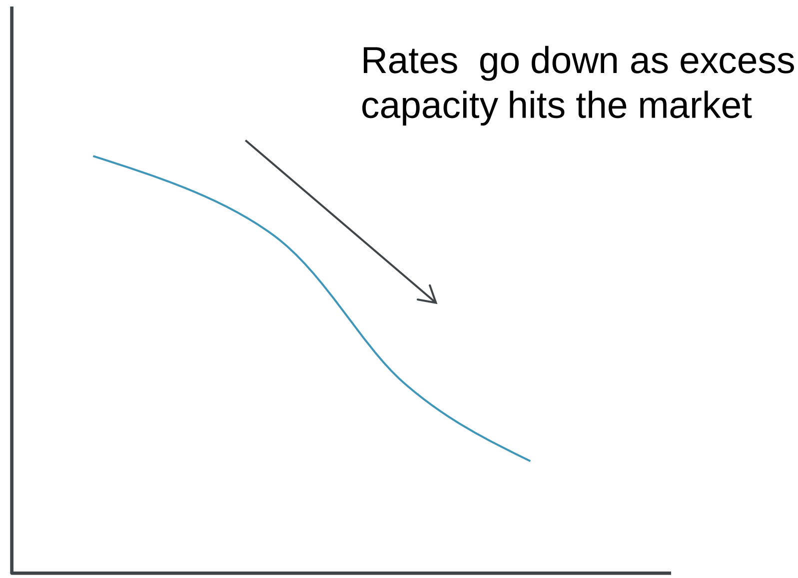
- Differing levels of importance when competing for specific business

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

The underwriting cycle



Opportunity to recover losses from previous downturn



Protecting market share through a strong balance sheet

Takaful

-sharing profits with policyholders: a general takaful example

Sharing of income to the operator	Agency Fee on contribution Profit sharing on investments Performance fee on u/w surplus	General insurer
Underwriting surplus	50% (max)	100%
Investment income on technical reserves	50% (max)	100%
Expense underrun profit	Limited by wakala fees	100%

- In a down market takaful shareholders need to provide capital support, no different from a general insurer except it is through a loan from the shareholders (a *qard*), an accounting entry, but to all intents and purposes having the same effect on solvency as a shareholders capital injection. **General insurers are able to accumulate operating reserves faster than takaful**.

Can takaful replace insurance completely?

- Life Insurance
  - Two components of life insurance, protection and savings.
  - Mortality experience is relatively stable and retakaful capacity assured.
  - Need to develop the sukuk market for savings product.
- Health Insurance
  - Significant expertise required to make health insurance work as it involves the health providers.
  - As claimants expect benefits to be “guaranteed”, takaful needs to adopt a prudent pricing basis.
  - Both claims frequency and claims severity can be volatile
  - Health takaful is unsuitable for newly established takaful operators

Can takaful replace insurance completely?

- Casualty/General Insurance
  - For big risks takaful may not be able to compete with insurance due to capacity and retakaful constraint
  - Personal lines with stable claim frequency and severity are ideal for takaful. However, takaful will find difficulty competing with the more established insurers which have better distribution and service levels.
  - Not suitable for takaful operator if the market is price conscious and it is competing with better established insurers which are better capitalised.

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Regulating takaful – making a difference

Regulating Takaful

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Direction of modern takaful globally

- Sudan has persevered with the Mutual model, but that has been through its government's decree. Shareholders makes meagre return on "capital".
- Bahrain mandates one takaful operating model but its takaful companies compete head on with insurers and most are still in a loss making position after over 5 years in operation.
- Takaful operators in UAE, Qatar and Oman profitability are driven by the investment performance of its property and equity markets as their underwriting retention is small and their assets (mainly shareholders capital) are invested primarily in the countries' properties and equities market due to the absence of an active secondary sukuk (bonds) market.

Direction of modern takaful globally

- Saudi Arabia has dispensed with the traditional takaful model for a mandated “co-operative” operating model. Insurers there compete head-on on price and services. The industry is still recovering from massive losses incurred due to the regulator’s move to strengthened technical reserves in 2014.
- In Malaysia Bank Negara has slowly brought the supervision and capital requirement of takaful operators to be in line with insurance. Is it still a takaful market or is it now just a “sharia compliant insurance” market?
- Globally, other than the surplus refund nature of takaful there is very little product differentiation between takaful and insurance. Outside of Malaysia, there is very little family (i.e. life insurance) takaful market.

Regulating takaful – the Saudi approach

- One fund – Participants share in the net surplus (minimum of 10%) of the Company rather than only the surplus from the risk/claim pool. All deficits arising are for the account of shareholders.
- Promote price competition between cooperative insurers. Classical trade off between premium volume and price among the insurers.
- Greater incentives for shareholders to compete as up to 90% of total surpluses accrue to shareholders.
- Full accountability to shareholders as all losses accrue to shareholders and shareholders are financially responsible for business decisions made by management.
- Reinsurance certainty as there is huge capacity in the global reinsurance market as compared to the retakaful market.

Regulating takaful – Bank Negara Malaysia's approach

- Although BNM does not mandate the takaful operating model, the market has gyrated to the operating model that makes the most commercial sense given the takaful regulations.
- Regulating takaful consistent with insurance ("level playing field") with attention to;
  - Sharia governance
  - Potential conflicts between shareholders and policyholders interest
- Supplemented by comprehensive regulations on
  - The takaful operating framework
  - Managing takaful intermediaries
  - Managing Sharia

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Moving Forward – One possible direction

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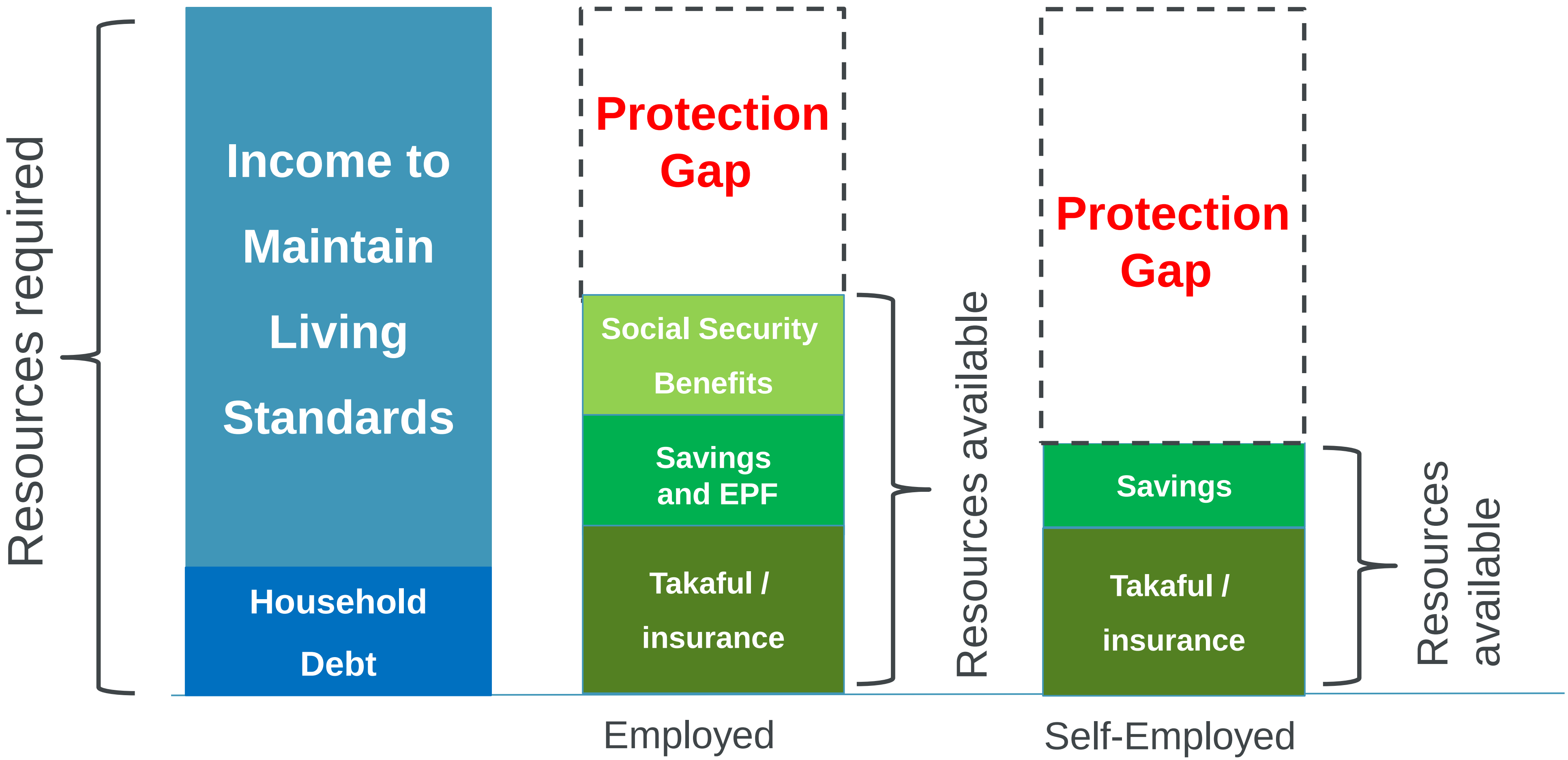
Is takaful making a difference in the insurance market?

- In Malaysia due to the presence of a (profitable) tariff market for fire and motor business the major attraction for takaful is the policyholders expectation of an underwriting surplus share.
- Due to the lack of product innovation, takaful globally are dependent on price, accessibility and service. Being new entities they operate at a significant disadvantage to more established insurers. Unless something changes, the future for takaful looks limited.
- The insurance industry has not changed much over the decades. Is it not time for an “Uber” or “AirBnB” make-over for this industry? Can takaful be remade to be that “disruptor”?

Some personal observations and views

- Where the capital provider is a party to the takaful operation, unless the return on capital employed is commensurate with the shareholders expectations, sooner or later the shareholders will withdraw from the takaful market.
- Return on capital employed is dependent on the Regulations in the country. Unless the regulations cater to the specific features of takaful and its role the insurance market, takaful will remain a “boutique” market.
- There has to be a holistic approach to the takaful industry which encompasses **regulations, consumer protection and government objectives**. Regulations by itself would not work.

Actuarial Partners Protection Gap Study for Malaysia - Methodology



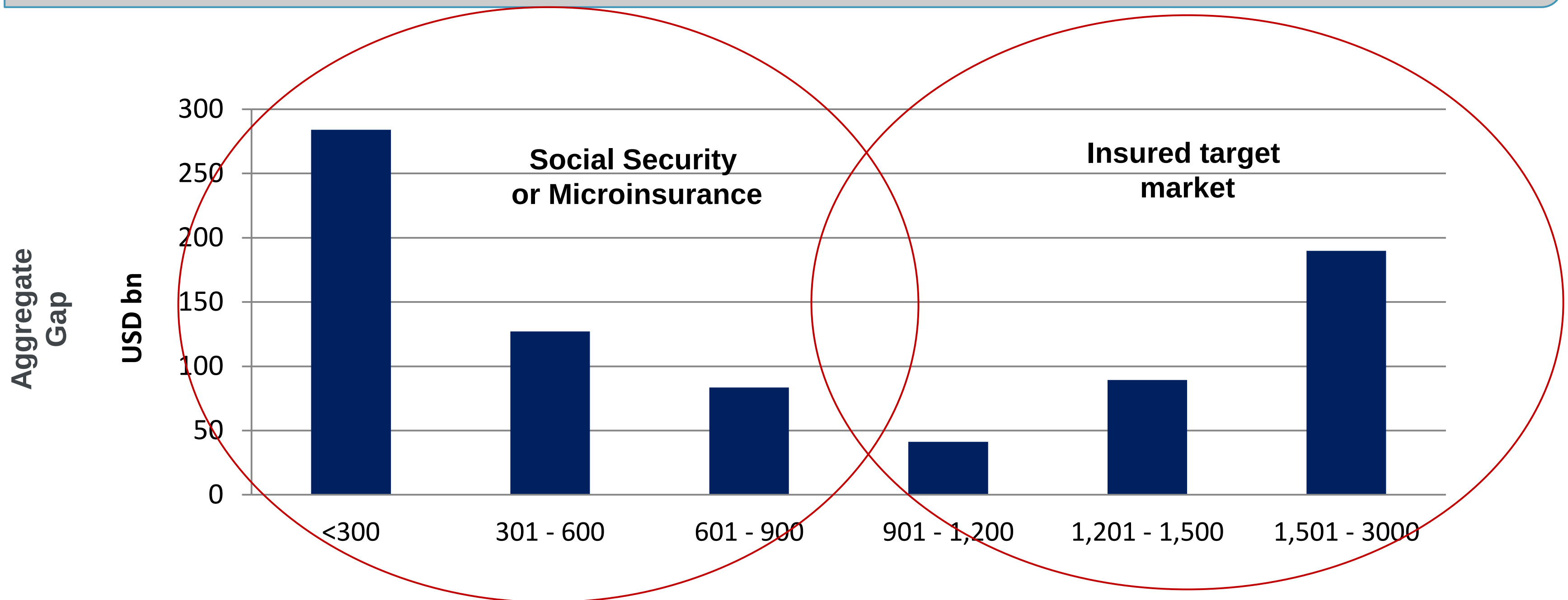
The Protection Gap in Malaysia in 2012

- The average gap per working person is USD63,000 or approximately 9 times average salary while the average sums assured for takaful policy in Malaysia is USD16,000.

- The actual gap per person will vary depending on the individual's family financial needs.

The Protection Gap - By Income Group

The largest aggregate gap is for those earning below USD300 a month (USD290bn), with an average gap of USD66,000 per person



Key reason for the gap: Lack of funds to buy insurance/takaful.

Nearly two-thirds of Malaysians earn less than USD600 a month.

Addressing the Protection Gap

- The bulk of the Malaysian population are unlikely to be of interest to commercially driven insurers/takaful operators as;
  - High cost of accessing this market
  - Small premium size
  - Profitable market still not fully tapped
- What is needed is a means of;
  - Utilising existing affinity groups, a “wholesale” rather than a “retail” approach
  - Structuring a self-insurance program for the group
    - Avoids price competition
    - Keeps any surplus within the group to be utilised as the group wishes
    - Aligns the interest of the members of the group to the financial health of the program

Back to Basics for Takaful?

- Takaful literally means ‘joint guarantee’, where individuals in the community jointly guarantee themselves against a loss or damage. This is the operating model for Mutuals and Friendly Societies in the UK.
- In such an arrangement
  - Limited distribution costs are incurred (i.e. limited marketing costs and commissions are incurred)
  - 100% of any surplus are distributed back to policyholders.
  - Limited pressure on premium rates, rates can be set based on past experience of the group itself, either based on risk factors or community rated.
- This operating model when run properly provide better service to its members and at a lower cost as the costs associated with the “middle-man” are either minimised or eliminated.

Discretionary Mutual
- The basis of a new takaful model?

- Discretionary Mutuals are operational in the United Kingdom(e.g. Military Mutual) and Australia(e.g. Unimutual).
- A Discretionary Mutual pays claims at the discretion of its Board. It is not an insurance company and therefore it is not subject to insurance supervision. Most importantly there are no requirements to maintain any explicit solvency margin.
- Claim payments are not guaranteed, however claimants can expect sympathetic claims handling and response.
- As for all intents and purposes as there is no contractual obligation to pay claims, the premiums paid can be considered as a donation to the Discretionary pool.

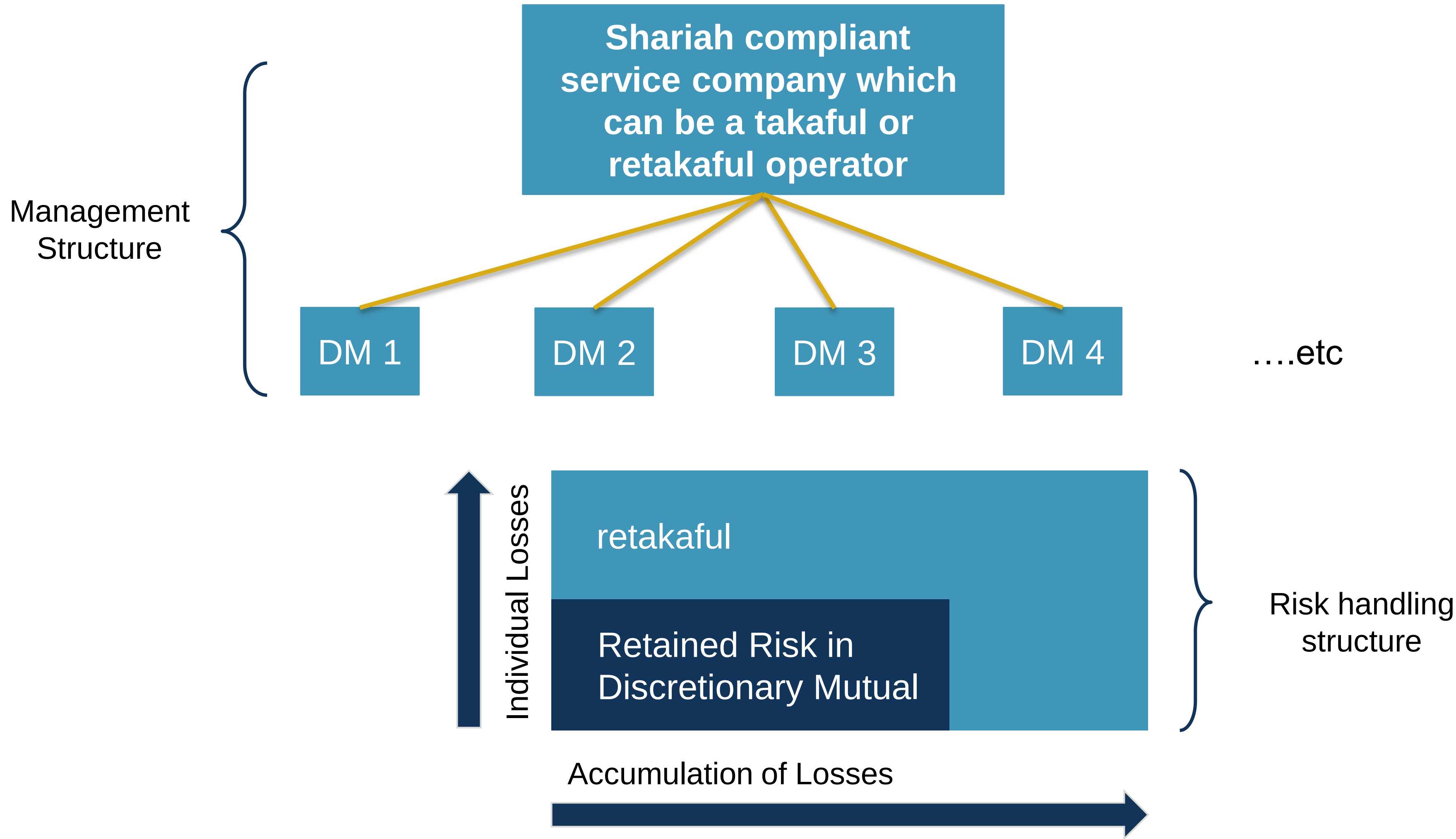
Who manages a Discretionary Mutual?

- Independent service companies (e.g. www.rmml.com) services Discretional Mutuals. These service companies are responsible for:
  - Underwriting
  - Claims processing
  - Policy documentation
  - Sales and marketing
  - Regulation and accounting
  - Risk Management
  - Legal services

Who manages a Discretionary Mutual?

- The Board of the Discretionary Mutual executes a contract with the service company where the Discretionary Mutual pays a pre-determined fee to the service company for the services provided. As the service company is external to the Discretionary Mutual the Board can replace the service company if unsatisfied with the services provided.

Business Structure



Fondos - self-insured agriculture funds

- Fondos are self insured funds formed by local growers and regulated by Mexico's Agriculture and Rural Insurance Fund law. Cover provided are limited to agriculture related losses and certain insurance on the life of the farmer.
- The other leg to the Scheme are the Integrating Agencies(IA) which oversees the activities of the Fondos. One IA can be responsible for many Fondos and they are responsible for enrolment, setting risk retention limits, settling claims, managing reinsurance and training. This allows scale to be built up quickly.
- Government's role is to provide premium subsidy and ensure availability of reinsurance capacity

Fondo's allocation of gross premium

Allocation of Original Gross Premium

100%	Stop Loss Reinsurance Cost (Average of 20% Gross Premium)
100%-20%=**80%**	Fondo's Administrative & Operative Expenses (Up to 25% of Gross Premium after Reinsurance Cost
80%-25%=**55%**	Fondo's Current Risk Reserves (CRR) (40 to 60% of Gross Premium to pay 1st Layer claims) (Level of CRR depends on Cost of Reinsurance)

Allocation of Underwriting Surplus

Special Contingency Reserve for CAT losses	25%
Labor Liabilities Reserves for Fondo's Employees or extra Expenses/Reserves	5%
Social Fund (available to be used/spent as per Fondo's decision)	70%

Source: *Mexico: Agriculture Insurance Market Review*

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How can Regulations make a difference to takaful?

- Limiting regulations to mainly managing solvency may work for the insurance market, where regulations are designed to supervise a competitive market, but it does not promote takaful.
- Takaful cannot compete with insurers through repeated underwriting cycles without shareholders who are willing to accept a lower return on capital employed.
- To prosper takaful has to be <u>different</u> from insurance. It must be more transparent and seen to be fairer to consumers.

How can Regulations make a difference to takaful?

- Government should allow the establishment of Discretionary Mutuals/Fondos(DM/F) and establish suitable legislations to ensure these are managed professionally.
- Existing takaful/retakaful operators be allowed to be “service” providers to these DM/F. This will allow takaful operators to quickly establish scale and ensure their financial sustainability.
- Takaful regulations should facilitate the development of the takaful market as supplementing the existing insurance market rather than as part of that market.

What can happen to takaful…

Salaam advertisement.....

Source: Brandon - Cross, B. 2008

Questions

Comments