# The growing importance of Takaful insurance

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This paper focuses on the challenges faced by the takaful industry in enhancing the transparency and monitoring of this business. There are challenges in collation, analyzing and dissemination of credible and relevant financial and technical statistics. There are challenges of standardization in accounting and operational approaches by markets, regions and jurisdictions and there are challenges of how takaful standards being put together by takaful bodies like AAOIFI and IFSB align with insurance standards set by IAIS, IFRS etc. Overcoming these challenges is of paramount importance as takaful is an integral part of the global insurance industry, the fastest growing, and likely to increase the overall size of the insurance industry manifold in years to come.

Islamic Finance and Takaful is a growing global phenomenon, contributing positively and substantially to the world economy. Although still about 5% of the global financial industry, the assets of Islamic financial institutions stood at nearly $1 trillion in 2009. These assets grew five-fold since 2003. It took 40 years for the Islamic Finance industry to reach this size, but it is likely to only take 5 years to double this size. The Moody's believe that the full potential is at least $5 trillion.

The main spread of Islamic Finance and Takaful has been in the Middle East and parts of Asia, Africa and Europe. Takaful grew at a compound annual growth rate of 39% over 2005-08 in terms of global takaful premiums, 45% in the GCC, and 28% in South East Asia. The comparative growth of global insurance was 7%, for the GCC 20% and for SEA 23.5%. The estimated size of the global takaful premium was USD5.3bn in 2008and USD8.9bn in 2010. Takaful is still a small sub-set of the global insurance premiums which stood at $4.2 trillion in 2008, but it is growing fast.

Takaful first started in 1979 in Sudan, soon followed by the countries in the GCC. It is now sold in 32 countries, making inroads in markets and customer segments where conventional insurance has hitherto failed to successfully penetrate.

There were some 179 takaful companies and windows (20%) in 2008, and this number in 2010 could easily be in excess of 200. The total capital committed within the takaful industry in 2007 was around US$3.5bn.

| Regions (Sept 2008) | Takaful Co's & windows |
|---|---|
| Middle East | 69 |
| Africa | 27 |
| Asia Pacific | 56 |
| The Rest | 27 |
| **Total** | **179** |

**About Takaful**

Islamic Finance and Takaful have its appeal for the strong ethics of the system of fairness, transparency, distribution of wealth leading to social goodness and environmentally friendly focus for generating economic activity. It discourages creating money from money and hence prohibits interest. It links deposits and investments to real underlying assets. With these principles the Islamic financial institutions have managed to maintain more consistent returns, even during the economic downturn. However, the industry was not totally immune to economic fallouts, especially from non-performing loans and depressed real estate assets.

The industry is still evolving and needs to innovate, especially in the areas of Asset Management, Bonds / Sukuks and Risk Hedging. These are important areas for takaful where good asset liability matching is paramount with secure and competitive returns.

Takaful of course is insurance like Conventional Insurance, and yet it has distinct differences. It compensates financially for protection against unforeseen risks just like conventional insurance. It is bound by and based on same scientific rules and actuarial approaches to mortality rates, morbidity rates, loss ratios, claims experience and discounted cash flows for calculating price of risk and evaluation of liabilities. And yet it is different. Takaful is like conventional mutual insurance as its policyholders conceptually own the co-operative takaful pool but Takaful also has shareholders to support the development and expansion plans which is different from mutual companies. To encapsulate takaful into a definition, here is how I would like to define it:

**Takaful Definition**

Takaful is a **participatory** form of insurance based on **risk sharing** by customers on **co-operative principles** instead of risk transfer to a third party, the company. The **customers participate in the technical and investment surplus** of insurance and reinsurance funds. The risk pool is **managed by the company** and the company is **run on a commercial basis** with corporate responsibilities towards its stakeholders, i.e., the **customers, employees and shareholders**. The business operations are **strictly focused on aspects of social goodness** with all its monies and funds invested according to **certain Shariah principles** for the **greater good of Society and Environment** at large **benefiting everyone** irrespective of religion.

**Future Potential**

The past growth of some 30% to 40% pa is expected to continue into the future and is likely to be even higher. This is because the mind-set of key players change through experience in reaching better understanding of takaful dynamics for each market and in finding new ways to unlock the vast potential highlighted by low penetration, high GDP levels and fast improving affluence of the middle classes. Much of the holding back in the current markets of takaful in the Middle East, Asia and Africa is to do with the mind set of those players (insurers, brokers, reinsurers) who are well entrenched in these markets in conventional insurance and see takaful as a niche only.

Takaful, for what it stands for in its essence of ethics, should rightly be the mainstream form of insurance in countries where takaful is a customer driven phenomenon.

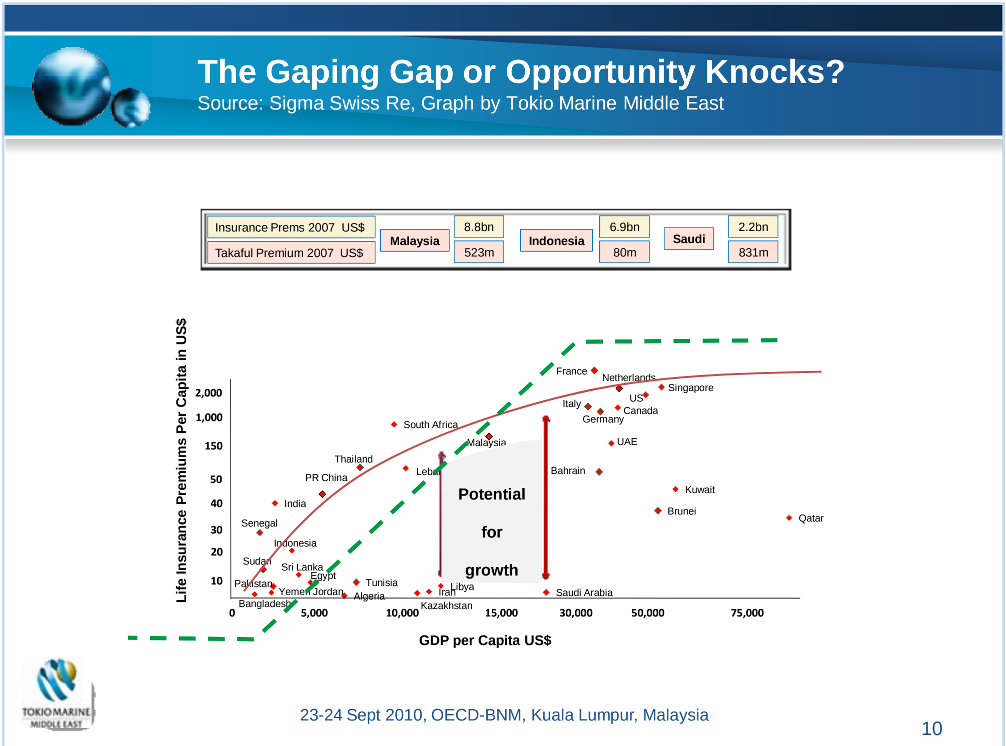
It is this customer driven push that led lots of local and regional companies to be established. Many big international players for many years continued to argue that takaful was no different from insurance because its end-result is the same. But the fact of the matter is that they did not really penetrate specific customer segments. The customer preference for takaful, i.e., the demand side, triumphed in the end, as big international players eventually established their own takaful companies and windows. Amongst such companies are Tokio Marine, AIG, Prudential, HSBC Insurance, Zurich, AXA, Munich Re, Swiss Re, Hannover Re etc.

Tokio Marine, operating in Saudi Arabia since 1967, was the first ever international player to have introduced takaful as a product in that market in 2001. By January 2008, it was offering takaful products in Saudi Arabia, Malaysia and Indonesia. The Group now also has a family retakaful company in Singapore and offers takaful products in Egypt.

The following S-Curve shows the size of potential in many markets where takaful is the password for unlocking this potential:

**S-Curve potential**

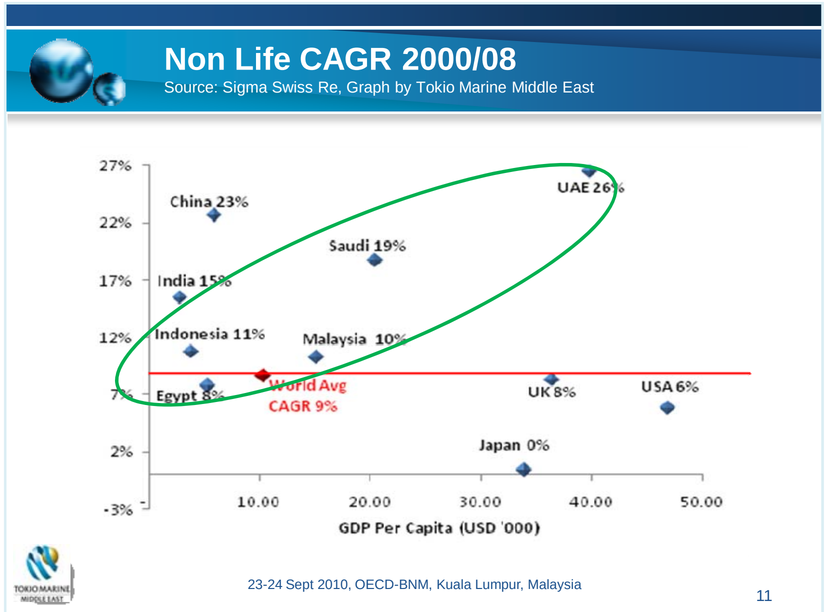
Source: Sigma Swiss Re, Graph by Tokio Marine Middle East




The S-Curve plots countries according to the GDP per capita and life insurance premium. For each country below the curve, the area up to the curve shows the gap that exists and hence the opportunity. If the market dynamics are right in terms of economic and political fundamentals, social development, income levels and insurance awareness, there is no reason why takaful should not be the key to success in achieving greater penetration of insurance.

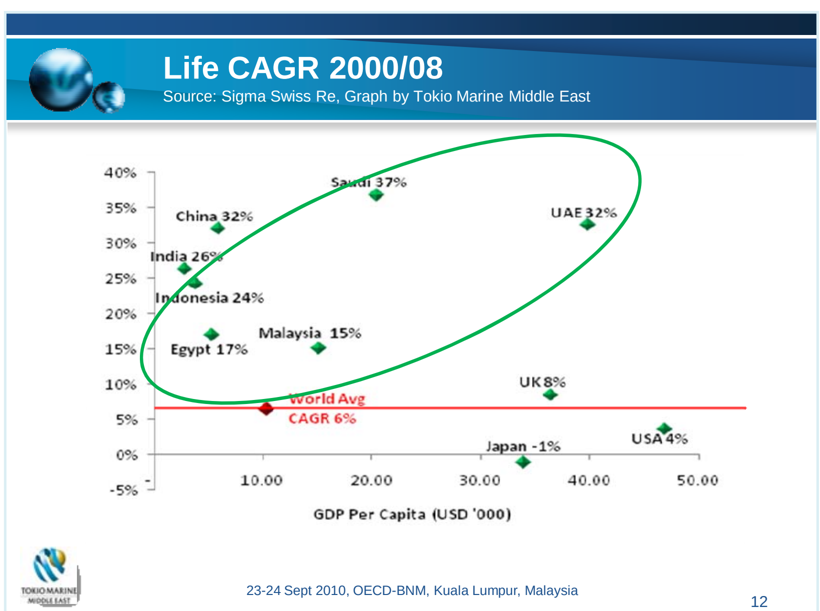
In 2008, Saudi Arabia had $6 spend on life insurance and yet other countries with lower GDP per capita such as Malaysia had much higher spend; US$226.

It is not surprising that the compound annual growth of insurance in countries within the middle part of the S curve is very high. The next two graphs illustrate this in putting the growth of insurance over 2000 to 2008 within the context of GDP per capita.




The world average growth was 9% in general insurance. Most countries with takaful potential have shown higher than average growth.

Whilst insurance awareness is low in many markets due to cultural reasons, takaful has all the room to grow. In life insurance, referring to the graph below, the growth in countries on the middle part of the S-curve have all shown impressive consistent growth:  Malaysia 15% pa, Egypt 17%, Indonesia 24%, UAE 32% and Saudi Arabia 37%. The US registered growth of 4% pa. The world average growth was 6% pa over 2000 to 2008.



The projected figures for the global size of takaful are estimated to be US$8.9bn in 2010 and between US$11bn to US$14bn by 2015 at a slower growth of between 9% and 11% pa. This is very much possible with new companies opening up and getting established in the GCC, especially in Saudi Arabia and the Levant region; and in the growing markets of the South East Asia and the Far East lead by Pakistan, Malaysia and Indonesia and perhaps India too. Europe holds a great deal of promise and a number of initiatives are being considered there. Takaful assets are estimated to grow to around US$30bn to US$40bn by 2015, approximately 40% of this backing family takaful business.

**Challenges and Issues in Takaful Statistics and Takaful sector monitoring**

The takaful industry is grappled with lack of credible industry data. There is no single credible source of industry information although various attempts are made to provide as up-to-date and authentic information as possible. The statistic provided in this paper is all estimated by different sources such as Ernst & Young, Sigma Swiss Re, regional publications, ARIG Directory etc. The main reasons for a lack of up-to-date and authentic information in takaful, and insurance for that matter, are:

a. Insurance, let alone takaful, is not understood properly as a business in many of these markets. As part of the financial services industry, insurance is not seen in the same way as banking for example. As a result, the local human capital in insurance is very small, especially in life insurance.
b. Takaful industry has grown at incredibly fast pace, leaving little time for co-ordination on issues of gathering information for the purposes of analyzing and disseminating it.
c. There has been lack of support at the regulatory level with not much pro-active action
d. The shareholders of takaful companies have guarded their turfs resulting in lack of disclosure of sufficient financial information

The supervisory management at the regulatory level has been weak in several countries where takaful is actively marketed, with few exceptions like Malaysia and some other countries. In several countries in the Middle East, Africa and parts of South East Asia, companies are at best required to provide broad formats for producing financial statements. This is slowly changing, with Pakistan and UAE introducing specific takaful provisions and introduction in Saudi Arabia of co-operative insurance laws. The fact that the co-operative insurance laws of Saudi Arabia are not entirely takaful compliant is a subject of another debate.

Takaful companies have an added layer of compliance in addition to the Statutory Reporting. This is to comply with the Shariah laws and principles. This is necessary for preserving the true takaful nature and characteristic in keeping with the customers' trust. Very few countries have specific takaful laws and most still require takaful companies to form part of existing laws governing conventional insurance. Many regulators maintain that separate laws for takaful may not be so necessary so long as the Regulator can accommodate the essentials of takaful business where it differs from conventional insurance through relevant guidelines, rules and ways of dealing with takaful operations. The industry bodies such as AAOIFI (Accounting and Auditing Organization of Islamic Financial Institutions) working on prudential accounting standards for example need to take account of the IFRS because there are major points of divergence that need to be considered.

As insurance and takaful is all about security, including the company's own rated security, the accounting standards are of paramount importance. The takaful businesses who report under the International Financial Reporting Standards (IFRS) are confronted with many complex issues. This is due to some fundamental differences between takaful and insurance, highlighted as follows:

**TAKAFUL-REPORTING UNDER IFRS**

**Key issues:**

1. Takaful is about risk sharing amongst the insured and not about risk transfer from the insured to the company.

2. Under conventional insurance the company bears the risk, and owns the underwriting and investment profit or loss. Under takaful there is a clear distinction between the income and outgo of the Risk Pool (or insurance fund) and the income and outgo of the Shareholders. The rights and responsibilities of each are clearly defined and one must be independent from the other. For example, the profits on shareholder funds must not be distributed to the policyholders and vice versa. The shareholders through employment of management of the Risk Pool, charge fees to the Pool, share in the investment profits of the risk pool for managing the investments and in some cases take incentive fee out of the surplus in the Risk Pool for efficiently managing the underwriting risks and exposing their capital to cover deficits reflecting excessive losses in the risk pool. This is known as Qard al Hasna (benevolent loan or simply Qard) and is an interest free loan provided to the participants fund by the shareholders.

3. The risk contributions (premiums) are a donation to the risk pool for collective benefit of all the insured participants. Premiums on the other hand are part of a buy-sell transaction between the policyholder and the conventional insurance company.

4. Under takaful, all contracts and operations need to ensure that there is no interest involved in any financial and investment transactions, and speculation and uncertainty

(*Gharar and Maisir*) are removed or minimized. Derivatives and instruments of pure speculation are therefore discouraged and in most cases not permitted.

5. To account for all of above, there are certain operational models adopted in takaful, whereas no such models exist in conventional insurance.

**Key complexities:**

1. The definition of insurance under IFRS is about Risk Transfer. The basic premise of Takaful is about Risk Sharing. How does one reconcile this fundamental difference which is the corner-stone of each system?

2. Takaful contributions are not revenue but a liability in the Risk Pool and claims and other expenses are a reduction of liability.

3. Some Shariah scholars maintain that funds related to takaful business are fiduciary in nature and should not even be shown in operators' balance sheet.

4. There is greater transparency in takaful accounting where assets and liabilities of the participants and Operator are segregated. This allows a fair share of surplus or deficit to be allocated to the participants in a transparent way. Conversely, if Takaful companies were to follow conventional insurance accounting regulations (which most of them do), a combined financial statement produced for the takaful company makes it difficult for stakeholders to assess and understand the results.

5. The Qard does not exist in conventional insurance although in conventional insurance at times when the insurance fund is depleted, the shareholders' reserves and equity come to the rescue. The issue with Qard is that on the one hand, it does not have a legal backing under the statutory regulations of a country and on the other hand, it is needed but not made obligatory by the Shariah requirements. The Qard can be considered a revenue transfer from the Operator to the Risk Pool and similar transfer back on repayment. Or, it can be an appropriation of profits from Operator's P&L account thereby reducing the Shareholder's equity and taken as capital transfer to the Risk Pool for what it is, an additional funding needed to absorb the deficit. This creates complexities if this amount is written off to absorb the deficit or is recoverable out of future profits of the risk pool. Further complexities arise on winding up of a risk pool that was given a large Qard injection. Qard remains whose obligation? The shareholders or participants?

**Conclusions**

Takaful has already contributed a lot to the global insurance industry by demonstrating that it can boldly go places and succeed where conventional insurance has not been able to succeed, especially in life insurance. It is still a small industry but has all the potential to increase the size of the global insurance business. Takaful however is not properly understood and there is still a great deal of work needed to increase its awareness. Takaful is for all, irrespective of faith like conventional insurance but takaful has its own unique proposition that must be preserved and strictly adhered to through compliance with Shariah rules and principles.

As a student and practitioner of takaful for the last 25 years, I have seen the industry evolve from products and services driven entirely by Shariah focus in its early days, to the other extreme of managing takaful companies with illusory Shariah compliance at the expense of innovation and commercial focus for driving the Top lines and Bottom lines.

Both extremes are however part of the natural evolutionary process, but now is the time after 30 years of existence of takaful industry to find the middle ground. The takaful industry needs to fine tune its balance between the Shariah compliance as an essential element for maintaining customer trust on the one hand, and aligning and complying with prudential accounting standards on the other. Through a harmonized dialogue between the takaful players, regulators, industry bodies such as AAOIFI and IFSB, the academia and Takaful associations and through the well-respected platforms such as this one, the OECD-BNM initiative, we collectively must enable this industry to achieve this middle ground.

There is a dire need for good disclosure of financial information in takaful. The regulators have been applying themselves to improve this situation but there is still more work needed in this area for the good of market understanding and for takaful industry’s credibility. The OECD initiative for enhancing insurance statistics and insurance sector monitoring currently excludes the Middle East and many other markets where takaful is written. It would do a great service to this industry by including these markets in their scope and coverage. There are a number of data sources now available, both at the regulatory level and private level that can be included to build a better picture of takaful industry as part of the global insurance statistics. A cohesive and co-ordinated approach is needed to work with these public and private sector institutions and Tokio Marine Middle East would be happy to help and connect the interested parties and take part in such initiatives.