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Are Takaful Models Converging?



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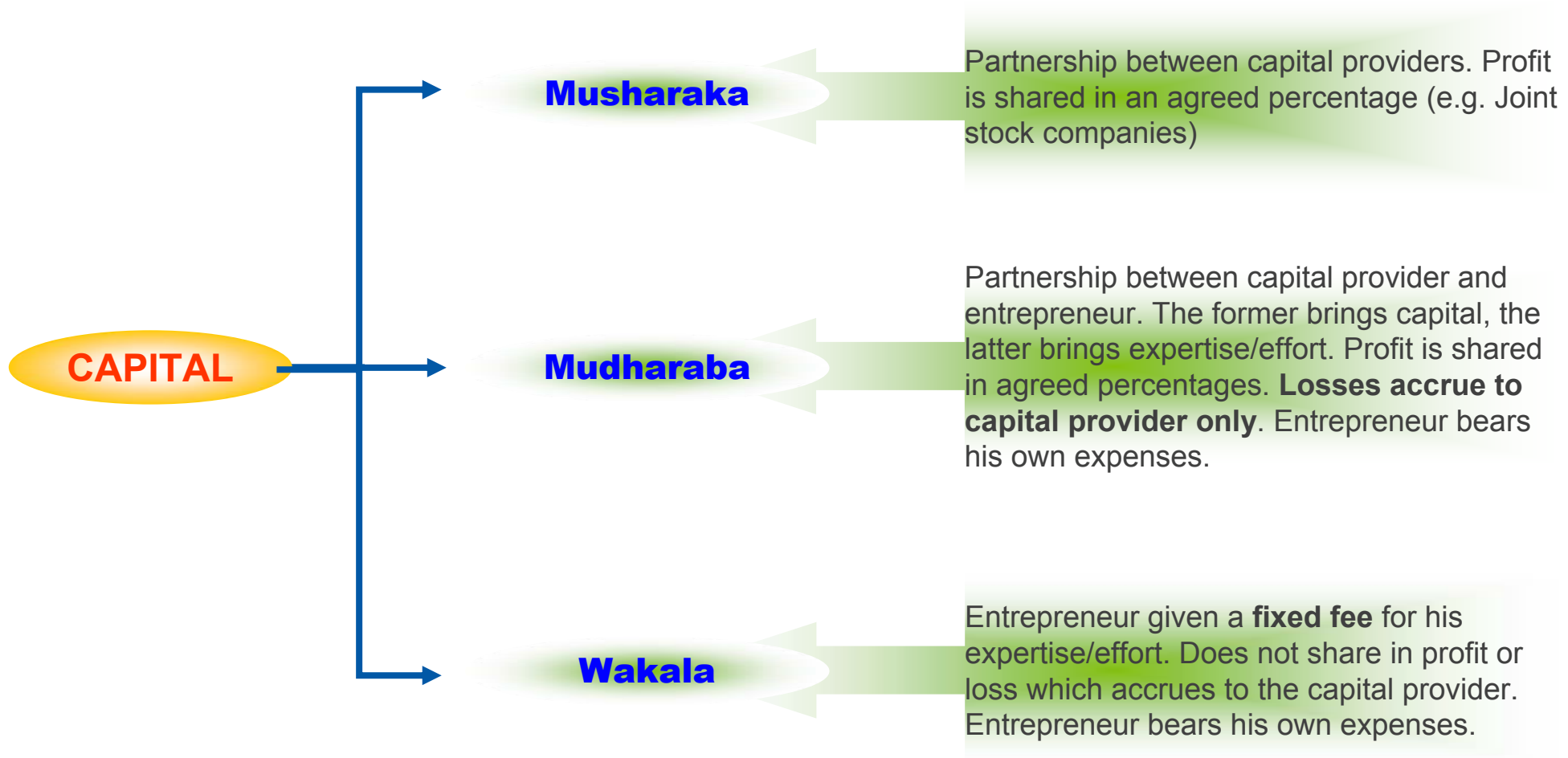
Is the issue related to Takaful Model or Takaful Contracts?

- Sharia's concern with conventional insurance lies in the insurance **contract** itself which 'contains major element of risk'.*
- In any Takaful operation, the issue should be what/which Sharia compliant contracts should be utilised.
- In choosing the contracts the Takaful Operator tends to be limited by the types of contracts already sanctioned by Sharia e.g. Mudharabah, Wakala, etc.

* Resolution No.9 Islamic Fiqh Academy (Jeddah 1985)

Sharia compliant contracts of compensation (sample)

- Commercial contracts are defined by *contract types*. Each contract type automatically assigns specific rights to the parties to the contract.



Takaful Model

- Takaful Companies have taken their preferred or regulatorily required Sharia compliant contract(s) and modelled a Takaful Operation around those contracts.
- Are these application and sometimes combination, of contracts which make up the operating (Takaful) Model still acceptable according to Sharia?
- Over a period of 20 years Malaysia's Takaful Operators have experimented with several Sharia approved contract types.

Convergence of Takaful Models

-the Malaysia Experience

- The first Takaful Company in Malaysia, Syarikat Takaful Malaysia (STM) was established in 1985 as composite operation. It used the Mudharabah contract as the basis of its Takaful Model.
- The idea was based on the contractual relationship between the 'capital provider' and the 'entrepreneur' in the Mudharabah contract. The participant (policyholder) was designated as the capital provider while the shareholders of the Takaful company was defined as the 'entrepreneur'.

Convergence of Takaful Models

-the Malaysia Experience

- Contribution (Premiums) less claims were deemed as 'profit' in the Tabarru' Fund and shared in a pre agreed percentage.
- All management expenses and any acquisition costs were met from the shareholders fund and therefore not borne by the policyholders.
- If there were no 'profit' in the Tabarru' Fund shareholders expenses will effectively not be recovered.
- The company basically used salaried agents and its parent bank to distribute its products.

Convergence of Takaful Models

-the Malaysia Experience

- For nearly 10 years STM was the only Takaful Company operating in Malaysia.
- This monopoly helped in easing competitive pressure on pricing (tend to be higher on this model) as it only had to compete with conventional insurance companies.
- The Mudharabah Model worked well for General Takaful (as 'profit' was realised yearly) but did not do show immediate results for the Family Takaful.
- The Takaful Operator has a strong incentive to generate 'profits' as otherwise expenses are not covered and their efforts will go unrewarded.
- The model has its detractors as surplus is not profit as intended under the Mudharabah contract.

Convergence of Takaful Models

-the Malaysia Experience

- The second Takaful Company, Takaful Nasional (TN) was established in 1994.
- It used the 'Modified' Mudharabah Model where certain expenses, for example commissions, were allowed to be charged to the Takaful (Tabarru') fund.
- The ability to charge commission to the Tabarru' fund allowed the company to support an (commission driven) agency force.

Convergence of Takaful Models

-the Malaysia Experience

- The Modified Mudharabah Model also worked well for General Takaful.
- However, as per the 'pure' Mudharabah Model this Model did not work as well for the Family Takaful.
- The ability to charge commission to the Tabarru' fund and thus able to support an agency based system, meant that it was able to grow faster than otherwise it could if it did not have an agency force.

Convergence of Takaful Models

- the Malaysia Experience

- The subsequent Takaful Operators in Malaysia adopted the Wakala contract as its base operating contract.
- The move away from Mudharabah was driven by
 - Sharia concerns as to the applicability of the Mudharabah contract for the underwriting surplus.
 - The ability of the Wakala contract to match operational expenses.
 - More pricing flexibility in a competitive market.

When is a Wakala Contract not a Wakala Contract?

- Although there is general consensus towards the Wakala contract in Takaful, there remain some differences in application.
- This is particularly evident in the distribution of underwriting surplus.
- Some (not all) Takaful Operators using the Wakala Model also share in the underwriting surplus. This is justified on the basis of an incentive compensation to the Takaful Operator. However, the application on this basis can be seen by some as a marriage of a wakala contract with a mudharabah contract for a particular service (i.e. underwriting), i.e. a fixed fee plus a percentage of profits.
- As all Takaful Operators do not share in underwriting loss, sharing only in the underwriting surplus is technically difficult to justify.

Which Model is better?

- Due to its pure Mudharabah system, STM was able to declare higher profit rates to participants as compared to TN.
- TN's marketing advantage was the greater reach of its agency force and in some products, the lower rates it offered as compared to STM.
- The wakala model is superior as an operating commercial model as the wakala fees can be linked to the expenses incurred by the Takaful Operator which allows much greater risk management abilities.
- If surplus sharing to the Operator is also allowed, the Operator on the wakala model can expect to reap much better revenue as compared to that in either the Mudharabah model or the Modified Mudharabah model.
- Assuming that the premiums less claims is same for all models then the participants can expect a lower profit share under the wakala plus operator surplus sharing model.

Should there be a convergence of Takaful Models?

- Advantages
 - Simplifies comparison by the consumer
 - Simplifies how Takaful Companies are regulated, for example how solvency margins should be determined for Takaful operations.
 - Simplifies corporate governance.
- Disadvantages
 - Restricts product innovation.

Can the Wakala Model emerge as a Global Standard?

- Sudan uses the cooperative model which is very much still at the basic level, representing the original spirit of Takaful as it were. Shareholders are only entitled to a share of the profit derived from investing the assets of the cooperative Takaful Fund and are not obliged to fund any deficit. Currently it is unlikely that Sudan will move to the Wakala Model unless there is a change in the *fatwa* of its Sharia.
- Takaful Operators in Bahrain are mandated to use the Wakala contract for underwriting and the Mudharabah contract for investment. There are no disagreement as to this requirement.
- Generally new Takaful and Retakaful companies globally are using the Wakala contract as the basis of its model.
- The remaining issue is whether under the wakala contract there can be a sharing of underwriting surplus with the Takaful Operator. Current AAOIFI standards do not allow Operators to share in underwriting surplus.

The Waqf question

- the issue

- Another point of contention is the relationship between the Takaful fund, the participants and the shareholders of the Takaful Operation.
- Under the Tabarru' concept of donation towards the Takaful fund, there remain some questions on whether the funds in the Takaful fund still belongs to the Participants until it is disbursed. If so, it is subject to the participant's zakat obligation and Muslim inheritance law.
- The Waqf (Trust Fund) concept establishes a Sharia recognised legal entity to which the participant surrenders all legal rights he has on his contributions to the Waqf Fund.
- As far as we know this is generally an issue only in Pakistan, though South Africa has also adopted this Waqf fund idea.

The Waqf question

- should this be seen as a difference in model?

- The proposed introduction of the Waqf is to remove ambiguity as to the legal status of the Tabarru' fund under Sharia law.
- The waqf concept introduces other new issues while seemingly able to resolve some ambiguity in the Takaful Model.
- Nonetheless, there are several corporate governance issues that Takaful Operators need to be aware of in the existing Tabarru' fund concept.

Does Sharia have the Final Say on the Model?

- Experience have shown that Sharia scholars has differences in opinion on issues affecting Islamic Finance. There are also ‘Sharia based decisions’ and ‘Sharia compliant decisions’.
 - this raises the possibility of Sharia arbitrage.
- Sharia scholars are usually not insurance experts (they are not sharia scholars, management consultants and actuary all rolled into one).
 - AAOIFI Governance Standard for IFI No.1 paragraph 14 would indicate that management is responsible for properly complying with Islamic Sharia Rules and Principles. The Sharia Supervisory Board is entrusted with forming an independent opinion of whether or not management has fulfilled this obligation.
 - Clearly the Sharia Supervisory Board (SSB) plays the role of a Peer Reviewer of managements decisions on Sharia issues
 - Management should not initially use the SSB to form its opinion. If necessary the management should seek the views of other Sharia scholars (other then those in the SSB). This would reinforce the SSB role as a Peer Reviewer.

Conclusion

- The initial takaful models tend to be driven by “Sharia up” decisions rather than “business down” decisions.
- The new Takaful Operators generally take a business view of Takaful. This is correct but there is a danger that the spirit of Takaful may be lost or severely diluted in the process.
- With some exceptions, globally there would seem to be a general convergence to the wakala contract in Takaful.
- There is still the outstanding issue of whether the Takaful Operator should share in underwriting surplus. Technically it is difficult to justify shareholders sharing in surplus while not sharing in the deficit.
- Ultimately the regulators in each country will determine (whether directly or indirectly) or influence the path of Takaful through capital and solvency requirements and by considering consumers interest.

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