

# **4<sup>th</sup> Annual World Takaful Conference 2009**

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## **Insights into The IIRA Rating Process for Takaful Operators**

By: J. M. McMullen, Senior Vice President  
Islamic International Rating Agency (IIRA), Bahrain



الوكالة الإسلامية الدولية للتصنيف  
Islamic International Rating Agency

# Emergence of Takaful Industry

- Conventional insurance believed by Muslim scholars to include uncertainty in underwriting and operations and unlawful placements in investments
- Takaful emerged to remove these objections and to bring about a mutually cooperative model
- Takaful is a term for “helping each other out” which is the behavioral foundation of this industry
- In principle, takaful is not sold, but participation is invited



# Conventional vs. Takaful

Two insurance concepts: **risk shifting** and **pooling**

- In conventional, risk is shifted from insured to insurer for premium
- In Takaful, risk is shared in the pool of funds (Takaful fund) – insured has no claim over operator's fund which belongs to the shareholders of the operator
- In both cases risk pooling is the basis for insurance activity
- Takaful only insures risk from Shari'a compliant activity
- Customers (Participants) need not be Shari'a compliant



# Conventional vs. Takaful - *continued*

- Takaful has additional institutional body - the Shari'a Board
- Takaful only invests in Shari'a compliant investments
- This limitation is one of the major challenges



# Takaful Structures and Business Models –

## Typically two components:

- An Operator, which manages the underwriting and investments
- The takaful fund to which participants pay their premiums or contributions

## Operator, depending on the arrangement is compensated in various ways

- **Wakalah (Agency)**

The operator administers the pool funds derived from the participants, paying claims and investing excess amounts. For this, the operator receives an agreed fee

- **Mudarib Model**

In this case, the operator is mudarib under a contract which specifies how profits are shared, or losses borne. Usually, the participants, as capital providers, bear any losses



# Obligations of different parties

- Conventional insurance as a company is responsible for claims and expenses, indeed all obligations
- In Takaful each fund has distinct obligations
  - Operator's/Shareholders' Fund: obligation to pay management expenses and contractual obligations other than claims and to provide Qard Hassan
  - Takaful Fund: obligation to pay claims and pay back any Qard Hassan and fees (Wakalas / Mudarib) to the operator
- Takaful Operator has no access to Takaful fund



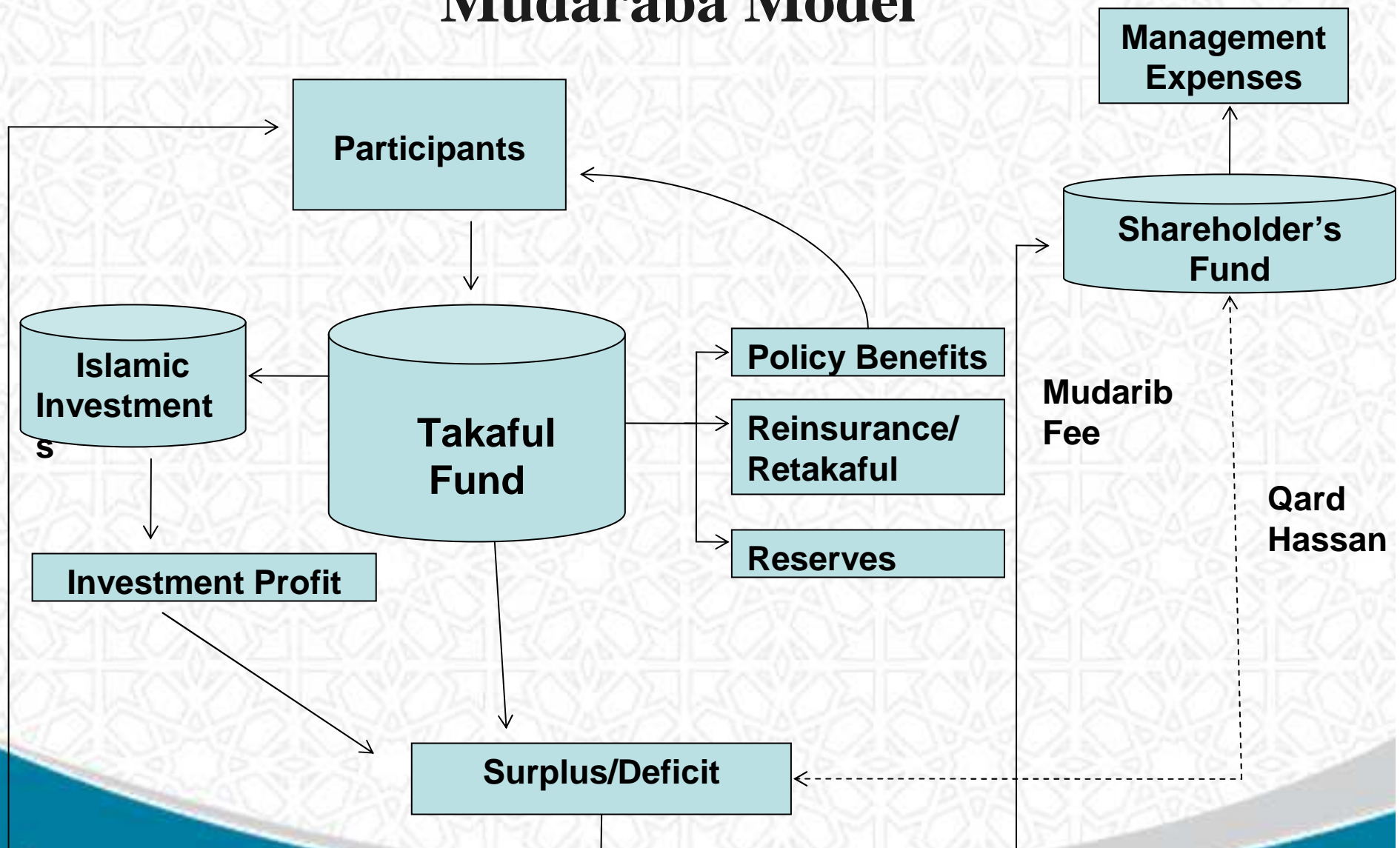
# Sources of Income of different parties

- Conventional insurance sources of income are premiums, investment income and gains and other.
- In Takaful each fund has distinct sources:
  - Operator's Fund: investment income; mudarib's share; and Wakala management fees
  - Takaful Fund: investment income as rabbul mal and contributions (premiums)

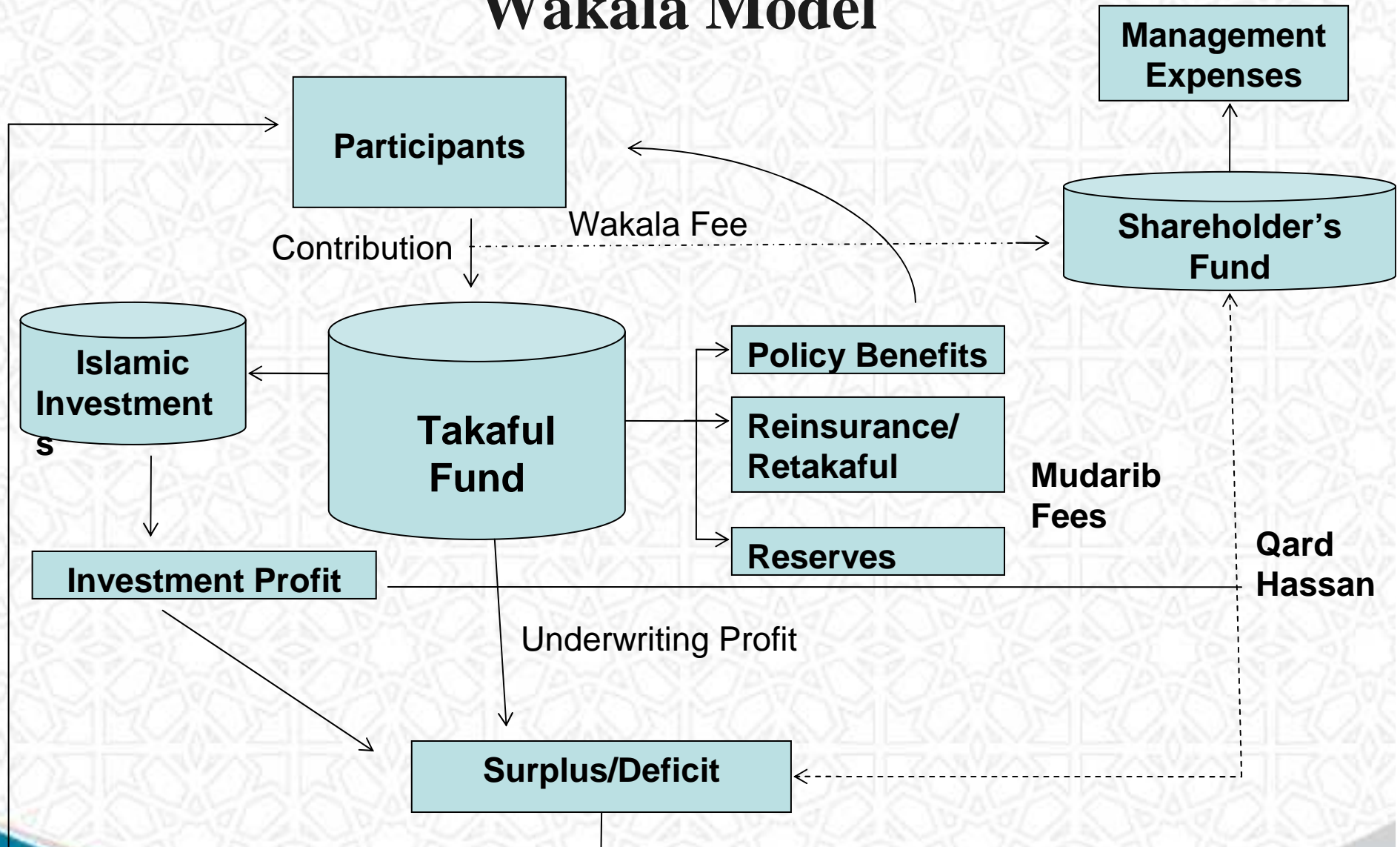


# Takaful Business Models

## Mudaraba Model



# Wakala Model



# IIRA's Ratings

- Takaful Financial Strength Rating is an independent assessment of the company's financial strength and its capacity to meet obligations to policy holders and other contract holders.
- Shari'a Quality Rating is an independent assessment of the structure and mechanisms in place to ensure compliance with Shari'a.



# Risks for Takaful Companies

- Takaful Company as Mudarib or Wakeel faces negligence risk if it applies imprudent investment strategy
- Non-Shari'a compliance may jeopardize reputation of the entity
- Takaful is not directly exposed to interest rate risk but this means lesser investment universe in today's environment
- Liquidity Risk is higher due to lack of investment alternatives and concentration in Equity, Real Estate and Sukuk and lack of financial flexibility in raising funds.
- Market Risk – applies to both conventional and Shari'a compliant businesses



# IIRA Rating Criteria

## The Market and Country Risk

- **Corporate and Political Governance**
  - **Country's legal system**
  - **Government regulations**
  - **Reporting regimes and examination programs**
- **Economic Environment**
  - **GDP composition, growth and outlook**
  - **Fiscal management and money growth**
  - **Financial volatility**



# **Market and Country Risk – *continued***

- **Insurance Environment**
  - **Accounting Standards**
  - **Regulatory Bodies**
  - **Distribution Channels**
  - **Overall Development**



# Keys to Company Analysis

- **Business Plan and Strategy** – Marketing and distribution strategy, Targeted market segments, Risk management, diversification, investment strategy, etc.
- **Management** – Experience, risk appetite, decision making hierarchy, etc.
- **Operational Controls** – SQR rating and compliance considerations; business plans and procedures, audit and control systems, reserve valuation methodology, etc.
- **Retakaful Program** – Re Takaful company assessment, risk concentration and exposure, types of treaties, etc.



# Balance Sheet Strength

- **Capitalization**
  - **Capital Structure**
  - **Credit Facilities**
  - **Regulatory Requirements**
  - **Capital generation**
  - **Investment strategy**
  - **Asset and Liability Management**



# Balance Sheet Strength

## Key elements

- **Maturity and structure of liabilities**
- **Ability to generate sufficient cash flow from operating/insurance activities**
- **Investment portfolio and its marketability**



# Balance Sheet Strength

- **Asset Quality**
  - **Diversification of asset book, and in particular assets that exceed 5% of capital**
  - **Risk of default**
  - **Capital and surplus adequacy**
  - **Loss reserve adequacy**



## **Operating Performance**

- **Quality and sustainability of profits**
- **Contribution and investment income composition**
- **Breadth of business lines and investment portfolio**
- **Rate of premium increases**
- **Rate of growth in the customer base**
- **Risk exposure**



# Shari'a Quality Assessment

- **Shari'a Committee (S.C)**
- **Internal Shari'a control mechanism**
- **Training program in Islamic Insurance**
- **Investment methods of Takaful funds**
- **Treatment of surplus**
- **How to deal with deficit**
- **Re-insurance arrangements**
- **Identity and corporate image**
- **Mechanism for dealing with Non-Shari'a compliant income, any other violations**



# Thank You

Please visit our website [www.iirating.com](http://www.iirating.com) for information on rating methodologies and rating scales

## Contact Details:

**J. M. McMullen**  
**Sr. Vice President**  
**Islamic International Rating Agency**

**Telephone:** +973 17211606  
**Fax:** +973 17 211605  
**Email:** [jon.mcmullen@iirating.com](mailto:jon.mcmullen@iirating.com)  
**Webpage:** [www.iirating.com](http://www.iirating.com)  
**Address:** P.O. Box 20582  
Manama  
Kingdom of Bahrain

