

Criteria Report

Takaful Rating Methodology

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■ Summary

Takaful is a form of financial protection, similar to insurance, which is designed to be compliant with Islamic principles (Shari'ah) and which is based on the principle of solidarity and mutual guarantee. It has been established in its modern form for over 25 years and firms that offer Takaful protection have grown significantly in both number as well as scale in recent years. Fitch Ratings estimates that global Takaful contributions amounted to around USD2.6bn for 2006 and expects that this figure will increase substantially over the next decade.

This criteria report sets out the major factors that Fitch will consider as part of rating Takaful or re-Takaful obligations. Fitch will continue to apply the agency's conventional insurance and reinsurance rating methodology, as published in its existing criteria. However, due to important differences that exist between Takaful firms (including re-Takaful) and conventional re/insurers, the agency will allow for the specifics of Takaful firms in interpreting the conventional rating assessment categories. In addition, certain areas of analysis for a Takaful firm will require particular emphasis, such as the applicable legal and regulatory frameworks, risk concentrations, product design, risk management and corporate governance.

For example, Fitch considers that it will generally be very important for Takaful firms seeking a rating to demonstrate that substantially all assets of the business would be available to participants in a stress scenario. This is especially relevant where there is a segregation of assets between a "Takaful fund" (which holds the participant assets) and the "Takaful operator" (which manages the assets and transactions of the Takaful fund). Where such a segregation of assets exists, the agency will consider any valid method of demonstrating the fungibility (ie, transferability) of capital within the Takaful firm.

Although Fitch considers that Takaful firms can in many cases be assigned credit ratings, in cases of substantial legal uncertainty or where there appears to be an undue reliance on a firm's willingness to pay, the agency may be unable to assign ratings to such firms.

The publication of this report follows an exposure period during which comments were solicited from the industry on the agency's proposed methodology. To accompany this criteria report, a special report on Takaful ("*Takaful Review and Outlook*") has been published simultaneously. This separate special report includes information for those not familiar with the industry and sets out why Takaful is necessary, the key features of Takaful operations, as well as the prospects, opportunities and challenges for the industry.

■ Introduction

Islamic finance is an important emerging area in the global financial markets. This has certainly been true of Islamic banks, which have risen in prominence over the last 30 years, but also more recently for corporates, which have seen an increasing issuance of Sukuks (financial obligations that comply with Islamic law). Fitch has published a number of documents recently in respect of Islamic finance – “*Islamic Banking – Factors in Risk Assessment*”, “*Fitch’s Approach to Rating Sukuk*” and “*Demystifying Corporate Sukuk*”, all published on 5 March 2007 and all available at [www.fitchratings.com](http://www.fitchratings.com). Islamic insurance is also a significant growth market, particularly in Asia and the Middle East but potentially also among Muslim communities within more mature markets. The term used to describe financial protection that is similar to insurance and compliant with Islamic principles is Takaful.

The concept of Takaful is derived from an Arabic word meaning “guaranteeing each other” or “solidarity” and was approved by the Grand Council of Scholars in 1985. The concept of Ta’awun or mutual assistance is key to the operation of a Takaful firm, with participants agreeing to mutually support each other against losses. A related area is that of re-Takaful which refers to a reinsurer that operates in compliance with Islamic principles. In order to be compliant with Islamic principles, Takaful firms should ideally transact only with Islamic-compliant reinsurers. There are several ways that a Takaful and re-Takaful business can be structured and these are outlined in Fitch’s special report “*Takaful Review and Outlook*”, published simultaneously with this criteria document.

This criteria report assumes a working knowledge of the Takaful industry and focuses on Fitch’s methodology for rating Takaful firms. There are also appendices which set out a sample rating agenda, information request and guidelines for demonstrating the availability of Takaful operator assets to participants.

Fitch’s “*Takaful Review and Outlook*” is designed for those readers who are unfamiliar with Takaful terminology and structures or for those looking for additional detail. The agency recommends that readers without a working knowledge of the industry read this special report first, prior to the criteria. The Takaful Review and Outlook special report addresses the following:

- why is Takaful necessary?
- key features of Takaful operations
- the current Takaful landscape;

- prospects, opportunities and challenges;

The separate special report also has appendices as listed below:

- the flow of funds within generic Takaful operations;
- brief summary of an example regulatory regime;
- a glossary of terms.

■ Fitch’s Rating Approach for Takaful or Re-Takaful Firms

In the case of Takaful where so many permutations of both business model and legal environment exist, Fitch cannot apply a formulaic approach to assessing credit quality but must instead take a principle-based approach to reviewing credit quality based on relevant credit characteristics. This methodology is therefore not designed to address the specific Takaful model or legal circumstances of any particular country but to give guidance as to the principles that the agency will apply in each case.

Many of the rating factors to be considered for Takaful or re-Takaful firms will be the same as those for conventional insurers/reinsurers. These factors are listed in three Fitch criteria reports which are already in use by the agency: “*Non-Life Insurance Rating Criteria (Global)*”, “*Life Insurance Rating Criteria (Global)*” and “*Reinsurance Rating Criteria: Life and Non-Life (Global)*”. All of these documents were published on 2 March 2007 and are available on [www.fitchratings.com](http://www.fitchratings.com).

The following areas of analysis are therefore not a complete listing of all the rating factors that are assessed but those of particular importance in assessing a Takaful or re-Takaful firm. Although differences do exist in the way that Fitch assesses Takaful or re-Takaful firms, these differences are largely addressed in the conventional insurance and reinsurance criteria reports referenced above. The agency considers that additional issues arising from compliance with Islamic principles are very similar for the two types of firm. Therefore, references to Takaful in this document can generally also be understood as being equally applicable to re-Takaful firms.

Further details on terminology can be found as part of the “*Takaful Review and Outlook*”. However, for clarity, Fitch highlights the distinction between the Takaful fund (which collects contributions from participants and pays claims), the Takaful operator (which is the legal entity that administers the Takaful fund or funds) and the Takaful firm. Fitch uses the term “Takaful firm” (or “Takaful business”) to refer

to the combination of a Takaful fund and Takaful operator.

#### General Principles

**Types of Rating** – Fitch can assign a number of different types of ratings to entities or to different classes of obligation. These ratings include an Issuer Default Rating (IDR – an entity rating that represents an opinion on the probability of default), an Insurer Financial Strength rating (IFS – an issue rating applied to policyholder obligations and reflecting both the probability of default and the expected recovery in the event of default) and debt ratings (issue ratings applied to each type of security and also reflecting both the probability of default and expected recovery.)

Fitch expects that the IFS rating will be the most useful for Takaful firms looking to demonstrate the financial security offered by the Takaful fund (or funds). This rating would apply to the participant obligations of the Takaful fund and be based on the probability of default of this fund (IDR), together with the expected recovery. The agency would not expect to publish IDR ratings in most cases, given the fact that public debt is not usually issued by either the Takaful fund or operator.

In determining the IFS rating, the agency will generally use its standard insurance policyholder recovery assumption of 50%-70% where participants have priority access to assets within the Takaful firm. Where this priority is not in place (eg in the event of winding-up, participants and other creditors would rank *pari passu*), then the recovery assumption is liable to reduce to the range 30%-50%. Fitch's ultimate approach to recoveries in each case will therefore depend on the legal and regulatory regime of a particular jurisdiction.

As with the conventional insurance methodology, where the notional IDR is 'B+' or below, Fitch would perform a bespoke recovery analysis. It is also worth noting that some country domiciles are subject to a "soft-cap" for the level of recovery that can be assumed. These soft-caps are based on Fitch's assessment of the creditor-friendliness of various jurisdictions, as well as on the expected enforceability of security. A country ceiling also applies in some countries which can limit the issuer default rating (IDR) in some cases. Further details on these factors can be found in the criteria reports "*Country Specific Treatment of Recovery Ratings – Revised*" (dated 21 August 2006) and "*Country Ceilings*" (dated 17 August 2006), both of which are available on [www.fitchratings.com](http://www.fitchratings.com).

**Definition of Default** – The definition of default for a Takaful fund will be similar to that for a

conventional insurance company. A fund that does not meet its legal or contractual obligations will be in default.

**Overall Rating Approach** – An important element in establishing a rating approach for Takaful/re-Takaful firms with a separate Takaful operator and fund is to determine whether these should be reviewed separately or as a combined group. The agency considers that the rating approach for a non-commercial (co-operative) operation with no segregation of funds would be very similar to that of a conventional mutual insurer (subject to certain differences in emphasis). This section therefore focuses on cases where there is a segregation of funds within the Takaful business (eg the commercial Takaful model).

Fitch expects that in most cases, Takaful firms desiring a rating will need to demonstrate that participants do have recourse to the assets of the Takaful operator. In such cases, the assets of the full Takaful firm would be available to meet investment or underwriting losses and consequently the difference from a credit perspective between a Takaful firm and a conventional insurer is significantly reduced. That said, Fitch considers that it is still very important to understand the sources of the Takaful firm's financial strength. The agency will therefore seek to gain an understanding of the financial strength of the:

- **Takaful fund** (based on available resources within the fund relative to risk, underwriting and investment performance as well as the expected distributions to participants);
- **Takaful operator** (based on available resources held by the Takaful operator, performance of the operator and anticipated distributions to shareholders);
- **combined firm** (based on a consideration of the combined resources of the firm, together with its overall performance and expected distributions).

By looking at each of these elements individually, the agency will be better able to understand the components of the firm's financial strength and to identify potential weaknesses. The procedure also recognises that the Takaful operator and fund are managed separately and capital may not be fully fungible (ie, transferable) between the two. For example, in some cases a Takaful operator with a high expense ratio and weak capital could theoretically fail, even if the Takaful fund is performing well and has a significant surplus. It is therefore not sufficient to review the Takaful firm solely on an aggregate basis.

In addition, reviewing the fund, operator and combined firm separately helps to provide a better reflection of the way that the business is managed, enables improved comparisons to be made between Takaful firms and aids understanding of the distributions that may be paid to participants or shareholders.

If participants do not have full recourse to the assets of the Takaful operator, then Fitch would still start with a separate assessment of the Takaful fund and operator. The agency would then consider the extent to which the financial strength of the operator is likely to be available to support the fund. This may be affected by the willingness and the ability of the operator to support the fund, as well as being affected by the regulations in place. In particular, the existence of, and regulations surrounding, the Qard al-Hasanah will be important (see *Capitalisation and Financial Flexibility*).

Where participants have no legal recourse to the assets of the Takaful operator, the financial strength available to participants may be heavily dependent on the “willingness to pay” of the Takaful operator. Where willingness to pay is a critical rating factor and subject to substantial uncertainty, Fitch may be unable to assign a rating in such circumstances. Fitch may also be unable to assign a rating where legal uncertainty becomes pervasive.

#### Industry Review

This category of assessment includes a review of:

**The competitive environment in the sector, expected market development and customer loyalty** – The clarity and transparency of the products, together with the characteristics of the client base, may lead to greater loyalty than would generally be found at a conventional insurer. This greater loyalty is evident at many Islamic banks despite that fact that they do not pay interest, and the experience of Takaful firms might well prove to be similar. Currently, there are limited data to support this hypothesis and Fitch will take a reasonable view in each case.

**Reputational and Strategic Risk** – This can be a risk for firms that market themselves as Shari’ah-compliant, with the possibility that they could be deemed to be “not in compliance” by influential clerics, either internally or externally. Such a determination could affect existing participants, as well as the ability of the firm to attract new ones.

It is important to note, however, that Fitch will not “approve”, certify or evaluate Shari’ah compliance. The agency is well-versed in credit issues but is not well placed to determine what is or is not in

compliance with Islamic principles, which is a complex and subjective area. The agency will rely on the firm’s Shari’ah board and, where applicable, national (ie, regulatory) Shari’ah councils in this regard.

**Effectiveness of the Business Model** – Different jurisdictions have differing restrictions on the permitted business forms (eg Wakala, Mudaraba) and in some cases on the contributions that can be charged (ie, tariffs) or the maximum permitted Wakala fee or split of profits.

In order to be a viable business over the long term, a commercial Takaful firm needs to be able to offer a suitable return on capital to the shareholders of the Takaful operator. In the presence of some of the restrictions above, together with the small size of many firms and the Shari’ah requirement to avoid excessive profitability, it may prove a challenge for some companies to achieve adequate returns. Fitch will assess whether the business model in place is liable to generate returns for the shareholder that meet the shareholders’ expectations. Cooperative (non-commercial) Takaful businesses will not be subject to shareholder demands but still need to be capable of generating suitable internal capital and meeting the requirements of participants.

The agency expects that shareholders’ expectations will vary according to the degree to which their capital is at risk in the business. This in turn will often depend on the legal and regulatory framework or on the wording that is used in contractual documentation. The degree to which shareholder capital is at risk will therefore be one consideration in assessing what constitutes an adequate return to shareholders.

A number of Takaful firms have found it difficult to make adequate returns in the early years of operations, given regulated contribution rates and, in some cases, regulated fees. At some companies, the business model has evolved so that the Takaful operator receives not just a Wakala fee but also some additional element.

Fitch expects that the Takaful business model will continue to evolve and develop in future years to balance the respective needs of various stakeholders including the financial security of participant obligations and shareholder return requirements. The business model must also balance the necessity of Shari’ah and regulatory compliance, as well as the need for suitable risk management practices. The agency will assess to what extent the business model is able to evolve in order to satisfy these potentially conflicting objectives and stakeholder demands.

**Regulatory, Legal and Accounting Framework –**

In considering the regulatory, legal and accounting environment, the agency views the following areas as often being essential to the review and would expect to discuss these scenarios with a Takaful firm to be rated:

- What happens if the Takaful fund suffers unexpected losses and cannot pay claims?
  - If the business is wound up in this situation, do participants have access (recourse) to assets of the Takaful operator? Do they have priority over other creditors in this case?
  - Is a Qard al-Hasanah compulsory<sup>1</sup>? Would it still be compulsory after a winding-up of the operation? What are the terms of this interest-free loan? Would this compulsion be legally effective given existing statutes?
  - To what extent is capital fungible between products or between Takaful funds?
- What happens if the Takaful operator suffers unexpected losses and cannot meet its obligations?
  - Is support permitted from the fund to the operator? What controls would there be over this?
  - If the operator is wound up, would assets of the Takaful fund remain segregated and unavailable to meet debts of the operator?

The agency will also consider the perceived effectiveness of the regulatory regime, including the quality of supervision, capital requirements and risk management. The accounting environment is important but the agency expects that this disclosure will generally be supplemented by additional information supplied to Fitch by the Takaful business.

**Organisational Review**

The ability of a Takaful operator or fund to source additional resources if required is a key consideration for any form of insurer. The financial strength of a parent organisation is especially important for Takaful windows or subsidiaries of established insurers. Where the Takaful firm is part

<sup>1</sup> There are views that where a Qard al-Hasanah is compulsory (eg by legislation) this is no longer a Qard al-Hasanah since the nature of the Qard al-Hasanah requires the free will of the provider to grant the facility. This debate is beyond the scope of this paper, which focuses on credit issues. Without expressing a view on the debate, the agency continues to use the term ‘Qard al-Hasanah’ in these circumstances for clarity.

of a group, Fitch will use its group rating methodology “*Fitch’s approach to Rating Insurance Groups*”, dated 19 June 2007 and available at [www.fitchratings.com](http://www.fitchratings.com), to assess whether any uplift (or drag) is applicable to the rating of the Takaful fund.

**Operational Review**

This section of Fitch’s analysis will be largely similar to the agency’s approach to conventional insurers and consider items such as underwriting expertise, brand and franchise value, distribution capabilities, market share, business mix and administrative capabilities. As noted, Fitch will generally consider the operations of both the Takaful operator and fund separately, as well as the extent to which they complement each other. This assists the agency in isolating the firm’s strengths as well as areas of potential weakness. However, of particular importance for the assessment of the Takaful fund will be an assessment of the products offered to determine the level of risk that is associated with them.

The agency will also assess the Takaful business model that is used (mutual, Wakala, Mudaraba, or a combination of these) and the agreed fees or split of profits between the Takaful fund and the operator. The ability of the operator to reprice Wakala fees (which affects expense risk) as well as the general characteristics of the Takaful participants are also considered important. Such characteristics can provide a greater understanding of their likely risk and behaviour. For example, participant behaviour can affect persistency risk (ie, the risk of policies being cancelled or lapsing) and there can also be “key man risk” if all participants only have one or two main contacts at the firm.

In some cases, participants may be required to provide additional funds to meet losses arising. However, Fitch will usually give minimal credit for such potential additional capital due to the difficulties associated with enforcement in such cases.

Fitch will look to ensure that the individual Takaful firm (as opposed to the entire industry in that jurisdiction) is equipped to generate a suitable return for stakeholders relative to their expectations over the medium term. If this is not the case, then that specific Takaful business may not be viable over the long term.

Management expenses are a key area for Fitch to review. An efficient operation with a relatively low level of expenses can be a competitive advantage for any particular Takaful firm and this may also help to encourage new participants to join. Fitch will also

consider the extent to which management expenses relate to each business line, so that it can gauge how representative the profitability declared is of the true economic position for each line.

Underwriting procedures remain very important for a Takaful firm to ensure that risks accepted by the Takaful fund are suitably rewarded. The typical insurance difficulties of moral hazard (an insured individual takes less care) and adverse selection (a bad risk is more likely to seek insurance protection at a given price) are no less significant than for conventional insurers. Fitch will assess the underwriting procedures and consider whether there are any restrictions (legal, regulatory or social) which affect the company's ability to decline risks for renewal or to reprice business.

Fitch will seek to establish the extent to which the product documentation of the specific Takaful firm allows a set-off between various products that are offered. In general, Fitch considers that a firm which allows a set-off between products (ie, products that are performing well can help meet the obligations of those that are not, and distributions are only paid if there is a surplus on the whole fund rather than a single product) is generally lower risk than those that do not permit such a set-off. Again, this relates to the fungibility of assets within the entity, as well as the extent to which distributions are sensitive to the firm's overall performance.

The agency will also assess the likely scenario if the Takaful fund were to experience difficulties. For example, if the Takaful operator were to fail, could it be replaced to ensure that claims are paid and investments are managed? What are the internal guidelines for the approval of a Qard al-Hasanah if required by the fund? Fitch would usually expect such stress scenarios to have been contemplated by management, with relevant plans put in place.

#### Management Review

The review of management and corporate governance is one of the most challenging, but also one of the most important, areas of Fitch's review. This is as true for a Takaful firm as for any other form of insurance enterprise but there are also additional corporate governance considerations to take into account, as discussed below.

If there is a separation of assets between the Takaful operator and the Takaful fund, this can lead to heightened principal-agent challenges (ie, challenges arising from one party managing the interests of another where incentives are not fully aligned). Both Wakala and Mudaraba contracts offer protection to the operator from downside risk and, in the absence

of mitigating factors, could potentially encourage greater risk to be taken by the Takaful operator.

The agency will consider the degree to which incentives are aligned between parties and the effect that these incentives are liable to have on the actions of the operator. For example, a Wakala model based on contributions may encourage the Takaful operator to try to expand contributions. There is also a significant difference in the incentives for the operator depending on whether the Wakala fee is based on net contributions (ie, after reinsurance purchases) or gross contributions (before reinsurance purchases). In addition, the Mudaraba model may encourage greater risk to be taken on behalf of the participants as the operator shares in the upside but may not necessarily suffer the negative consequences.

Clearly, where legislation or contract wording results in the operator's shareholders being exposed to risk (eg through the winding-up regime or a compulsory, subordinated Qard al-Hasanah), this helps to align incentives and reduce, although not eliminate, such corporate governance issues.

A further, noteworthy element of corporate governance relates to the composition of, and interaction between, the Shari'ah board and the management board. These are two influential bodies with different roles, but it is nevertheless necessary for them to communicate with each other to avoid potential conflicts. Each of the boards should also have appropriate checks and balances so that they can be valuable forums for debate rather than simply be a notional construct designed to support the view of a single individual or group.

#### Financial Review

**Investments** – Fitch will not certify that investments are Shari'ah-compliant, but nevertheless, the investment review represents an important part of the overall analysis. The agency believes that Takaful firms are potentially at a disadvantage relative to conventional insurers, given the investment restrictions to which subjected (eg certain debt instruments are not permitted and restrictions exist on invested industries). Fitch will therefore assess the approach of management to this issue.

Investment restrictions associated with Shari'ah may have a credit impact, given the limited availability of Sukuk investments and the consequent difficulty of investing in high-quality assets, whilst avoiding investment concentrations. These investment concentrations may relate to individual names or individual industries (eg oil).

In addition, in some cases (although certainly not all), there appears to be a relatively high proportion of equity investments compared with conventional insurers, which increases the importance of assessing the risk associated with these instruments. Equity investments are generally associated with higher volatility than debt and so it will be a key area of focus to establish whether this results in higher risk compared with the situation for a conventional insurer. Fitch will also consider the extent to which investments are held with related parties. Such investments may be made on “soft” terms and can lead to a low quality of investment assets.

The liquidity of investments is also a key area to consider, given that many of the Takaful firm’s investments may not be listed. Although this is not an issue that is necessarily or exclusively associated with Takaful firms, it is a feature of many developing markets which may be exacerbated by the limited availability of investment options for a Takaful firm.

**Reserving** – As with any insurer, Fitch will consider the adequacy of current reserves. The agency would expect to establish this after making enquiries about the reserving process, the techniques applied and the historical reserving experience, as well as reviewing any available evidence such as external reserve studies. This review will establish whether there is a particular confidence level targeted for reserves and whether claims reserves are set on an undiscounted or discounted basis.

Fitch also aims to ascertain the extent to which contingency or equalisation reserves exist. Such reserves will be treated as part of available capital, in line with the agency’s usual treatment of such reported liabilities.

**Reinsurance** – The issues with reinsurance are to some extent similar to those regarding investments. Reinsurance is always an important area for Fitch, and so the agency will attempt to gain information on the structure of the reinsurance programme and the extent to which it can be relied on to offset risk. In the case of Takaful firms, the use of reinsurance to reduce underwriting risk can be extensive in some cases. Although the agency does take account of reduced underwriting risk stemming from reinsurance in its rating assessment, this benefit is partially offset by credit and dispute risk which can be significant. This is especially the case for Takaful firms that are using re-Takaful providers as there may be pressure to compromise security in return for gaining Shari’ah compliance. Equally, there may be a concentration of risk in the hands of a small number of re-Takaful firms, or in some cases the re-

Takaful firm used may have less pricing expertise than that of other conventional alternatives. Each of these would have credit implications which Fitch would take account of in its review.

**Profitability** – As with mutual insurance companies, assessments of profitability can be complicated for Takaful firms, given that in some cases they will not seek to maximise their profits. Another challenge is to establish what a reasonable rate of return is, as this depends on the extent to which shareholders’ capital is at risk. Fitch looks to establish the surplus that has been, and is likely to be, generated by the Takaful fund, as well as the way that this surplus is liable to be distributed (or retained) by the fund over time. Fitch will also seek to determine whether profits under a Mudaraba model are in fact distributed in accordance with the percentages stated ex ante or whether the firm offers some other (maybe more fixed) return to participants due to competitive pressures.

As well as any surplus arising within the fund, it is also necessary that the Takaful operator is able to generate an adequate return on capital in order to be a viable long-term business and generate more funds if required. The profitability of the Takaful operator can be assessed based on the funds that are employed in the business and by comparison to both absolute levels of return and that of similar operations.

When assessing this profitability, the agency will consider results both before the Zakat (compulsory religious charitable donation) and after. In effect, the Zakat is looked upon in a similar way to taxation.

**Capitalisation and Financial Flexibility** – Fitch’s approach to capitalisation will vary to some degree according to the applicable legislation and the degree to which capital within the firm is available to participants. However, the agency believes that it is always important to understand the capital position of both the Takaful fund and the operator (where these exist) so as to establish the source of financial strength for the firm. The following are areas that the agency expects to consider for each of these groups.

1. For mutual Takaful firms with no segregation of assets within the society:

These non-commercial Takaful firms are very similar to conventional mutual insurers in structure although they aim to ensure that their investments and products, for example, are compliant with Shari’ah principles.

In these cases, Fitch will assess capitalisation using its own capital model together with regulatory benchmarks. If a company has an in-house capital

model available, then the agency would also assess this model as part of its procedures, in line with its published methodology.

2. For Takaful Firms that do have a separate Takaful operator and Takaful fund.

For firms which do have a separate Takaful operator and Takaful fund, Fitch would review capitalisation from several perspectives:

a. Assessment of the Takaful Fund

In assessing the amount of capital required for the Takaful fund, the agency will look to assess the volatility and level of claims relative to contributions. The situation of Takaful participants is unlike that of most conventional insurance policyholders because they will often share in any surplus generated within the fund and so, in theory, should be more prepared to contribute a large amount relative to expected claims. This means that the ratio of claims to contributions (contribution loss ratio) may be lower than the equivalent (premium loss ratio) in a conventional insurer. Where this can be demonstrated to be the case, the likelihood of requiring additional capital is reduced and less capital is needed. In these cases, Fitch will consider this factor as part of its assessment of the Takaful business. However, the agency notes that in practice, competitive pressures or the existence of a tariff structure can make it very difficult to require contributions that are significantly higher than conventional alternatives.

Fitch will also take account of the extent to which surpluses on one product are able to compensate for losses on others and the consequent fungibility of capital between products. The more that capital is “trapped” or hypothecated to certain participants, the less efficient that capital is due to a reduced ability for product surpluses to offset capital needs. The less efficient the capital base (*ceteris paribus*), the more capital is liable to be required for a given level of financial strength.

b. Assessment of the Takaful Operator

The Takaful operator is effectively a service provider and needs to have sufficient capital to be able to withstand unexpected increases in management expenses or reductions in income. The agency will therefore assess the potential volatility of expenses, the ability of the Takaful operator to source additional capital if required and most importantly, the level, volatility and flexibility of the operator’s income.

The operator’s income is likely to be more volatile if it provides services based on the concept of

Mudaraba although the expected return is often higher. In addition, where the Wakala fee can be adjusted to fit in with expense levels, this serves to reduce capital requirements of the operator. A key consideration in assessing the capitalisation of the Takaful operator is the extent to which it has the resources (and the incentives) to run-off an operation that has closed to new business.

- c. Assessment of the Overall Firm (ie, the consolidation of Takaful fund and operator)

Fitch expects that in most cases, it will be important for commercial Takaful firms seeking a rating to be able to demonstrate the availability to participants of shareholder assets. Where a firm is able to demonstrate this availability, then Fitch will also consider the capitalisation of the Takaful firm on a firm-wide basis using Fitch’s proprietary capital tools. This would involve considering underwriting risk, asset risk and reinsurance recoverable risk, among others, for the firm as a whole and comparing these to total available capital (shareholders funds, the surplus in the Takaful fund, equalisation and contingency reserves with any relevant adjustments).

An outline of possible methods for demonstrating the availability to participants of shareholder assets is shown in diagrammatic form in *Appendix 2* and is also described below. However, these possibilities are not necessarily exclusive and Fitch is prepared to consider other mechanisms for making shareholder funds available to policyholders where these are applicable.

- **Suitable local legislation is in place** – Local legislation is such that in the case of a winding-up of the Takaful firm, participants have (preferential) legal recourse to the assets of the Takaful operator. In this case, the assets of the Takaful operator are directly available to participants of the Takaful fund and shareholders’ assets are therefore able to meet investment and underwriting risks.
- **Suitable Contractual and other Documentation** – In some jurisdictions, even if local legislation does not automatically grant policyholders recourse to the assets of the Takaful operator, it is still possible to obtain an equivalent effect through suitable wording of the Takaful certificate (insurance policy), memorandum of association and articles of association. Fitch therefore anticipates that with appropriate wording, firms may be able to demonstrate the availability to policyholders of a Takaful operator’s assets.

- **The Qard al-Hasanah is of a suitable form and compulsory even following a winding-up of the operation.** – In general, Fitch regards the Qard al-Hasanah as a mechanism for providing limited relief for short-term difficulties in the Takaful fund rather than as a mechanism for providing recourse to fund participants. The directors of a Takaful enterprise are required to act in the best interests of their shareholders and this is unlikely to extend to making interest-free loans to the Takaful funds where these funds are in financial difficulties. However, if the Qard al-Hasanah is compulsory and would remain compulsory even following a winding-up of the business (or suitable triggers are in place to require the loans to be made pre-winding-up) then this may lead to capital credit being available for expected future loans if the loans would be of a suitable type.

A Qard al-Hasanah will be regarded as being of a suitable type if the loans would be granted 100% equity credit according to Fitch's hybrid rating methodology. This would mean that loans must be i) subordinated to the interests of policyholders and ii) have suitable restrictions on repayment (eg the loan can only be repaid from surplus). Alternatively, full equity credit may also be available if the loan is required to be converted into a donation in certain defined circumstances.

In assessing whether or not a loan is compulsory following a winding-up, Fitch will consider the fact that, if not deemed otherwise by statute, a post-insolvency Qard al-Hasanah may be considered void in some cases. In general, such provisions may be subject to certain legal challenges, particularly where the Mudaraba model is used, and it will be important for companies to demonstrate not just that suitable wording is in place but also that the contractual wording would be effective and enforceable.

Regardless of whether the Qard al-Hasanah is compulsory, Fitch would expect to give capital credit for existing loans to the extent that the loans' features meet the agency's standard criteria for hybrid capital credit. Care needs to be taken to avoid double counting capitalisation from the interest-free loan when assessing the Takaful fund and the Takaful operator.

Further details on equity credit are available in Fitch's "*Takaful Review and Outlook*", dated 16 October 2007 (see section *Qard al-Hasanah*) and in the criteria report "*Equity Credit for Hybrids and Other Capital Securities*", dated 27 September 2006. Both of these documents are available at [www.fitchratings.com](http://www.fitchratings.com).

**Other Considerations for Takaful Firms that do have a separate Takaful operator and Takaful fund but where participants do not have recourse to the assets of the operator.**

Fitch currently expects that it will be relatively rare for it to rate a Takaful firm where policyholder assets do not have recourse to shareholder assets. For exceptions to this, Fitch would generally expect strong capitalisation within the Takaful fund itself or a highly demonstrable willingness to pay (eg established through the use of the agency's group rating methodology). Where there is no recourse to shareholder assets, Fitch would increase its focus on the capitalisation of the Takaful fund and make an assessment as to the potential benefit that the fund may gain from the Takaful operator. As previously noted, where the rating is entirely reliant on the willingness to pay, Fitch may not be able to rate the policyholder obligations.

In order to assess the willingness of a Takaful operator to provide support, the agency would consider factors such as how "core" the Takaful operations are to a larger group and potentially the degree of overlap between the shareholders of the Takaful operator and the Takaful participants.

That said, even where there is a high degree of overlap between the shareholders of the Takaful operator and the participants of the Takaful fund, these shareholders may still prefer to wind-up the operator (with these assets benefiting shareholders in proportion to their original stakes) rather than passing all of these surplus assets to the Takaful fund through an interest-free loan for the benefit of those participants with losses on their policies.

**Other Capitalisation Factors**

Many Takaful firms either choose or are required to build up capital within the participants' fund. This can be achieved either through allocating a certain percentage of the profits to build up as surplus or by building up contingency or equalisation reserves. Such actions serve to reduce the dependency of the Takaful fund on the resources of the operator and in time would be expected to improve the returns on capital to the shareholders of the operator. Although these reserves are frequently very low at the moment, given the relatively short track record of many Takaful firms, Fitch expects them to become increasingly significant in the future and to become an important element of many Takaful firms' business model.

Finally, it should be noted that Takaful firms may have more limited access to funding, given the fact that they are not usually able to issue hybrid debt. In some cases, this may mean that Takaful firms have

lower financial flexibility (ie, ability to source additional funds if required) than equivalent conventional insurers. Although financial flexibility is generally seen as a positive rating factor; given the size of most Takaful firms, this difference in access to debt markets is currently more theoretical than actual in the majority of cases.

#### Enterprise Risk Management (ERM)

Risk management issues that would affect many companies in the main Takaful regions would include the control of aggregation exposure to catastrophic risk (eg earthquake, windstorm, flu pandemic) and the concentration of risk in particular industries (eg oil). However, enterprise risk management for a Shari'ah-compliant firm can present additional challenges compared with a conventional insurer, given the potential for risk concentrations and the more limited risk mitigating instruments that are available. Against this, Fitch will weigh the potentially offsetting impact of product design, together with the cooperative nature of Takaful firms which may in some cases reduce risk appetite.

The question of enterprise risk management is particularly pertinent for the larger multinational insurers and reinsurers that have opened up Takaful subsidiaries or windows. Such multinational insurers have been devoting significantly increased resources to enterprise risk management and a common method of operation is the use of intragroup reinsurance arrangements in order to centralise risks. In the case of Takaful operations that are part of conventional firms, such an arrangement may not be possible without violating Shari'ah principles, and so alternative methodologies for increasing the fungibility of capital within the group may need to be explored.

For smaller Takaful players, the dominant issues around ERM may concern the quality of information that is provided to the board as well as its timeliness. Where the accounting or risk team is inexperienced, part-time or reliant on key individuals, risk factors may be somewhat elevated. All Takaful firms need to ensure that they have suitable controls and training procedures to ensure that the principles of Shari'ah are not inadvertently breached and to protect the reputation of the firm.

#### Other Factors

Many Takaful firms have a limited operating history, given the large number of relatively recent start-up companies. Fitch can and does assign ratings to start-up operations based on a close inspection of the business plan, management team and business environment. However, the agency believes that such operations are usually subject to greater risks

than those that have been operating for some time and are therefore more established in their market with a seasoned portfolio. As a result, firms that have a short operating history would usually have a higher credit risk compared with a more mature operation. Such elements can be offset to a greater or lesser extent by an experienced management team, other business strengths and by group support.

#### ■ Conclusion

Fitch is conscious of the important differences that exist between Takaful firms and conventional insurers. The agency considers that non-commercial (mutual) Takaful societies which do not have segregated funds can be rated in a similar way to conventional mutual players, albeit with different emphasis on some areas of Fitch's standard rating approach. However, for commercial insurers in particular, careful consideration is required of the legal environment, the contractual status of obligations, the business model used as well as the applicable regulations.

For all Takaful firms, Fitch will take into account investment concentrations where these exist, potential corporate governance issues and in some cases, relatively short operating histories. Against these issues, the agency will balance the firm's risk appetite and the impact of product design as well as other risk mitigation techniques which have been employed by management. Fitch expects that only the strongest Takaful firms are likely to be able to achieve investment-grade ratings.

The agency expects that for most commercial Takaful firms at the present time, the availability of shareholders' assets to help meet participant claims will play a substantial role in establishing suitable protection for participants. Fitch therefore considers that it will generally be important for a rated firm to be able to demonstrate the availability to participants of shareholders' funds in the event of financial stress.

Possible methods of demonstrating the availability of shareholder assets to participants include, but are not limited to:

- suitable legislation being in place allowing participants recourse to the assets of the Takaful operator in the event of a winding-up;
- suitable wording of contracts as well as memorandum and articles of association to have the same effect as the method above; or
- credit for some part of shareholders' assets may be available to the extent that these assets have already been loaned to the Takaful fund. In order to receive credit, this loan would either have to be subordinated to the interests of

policyholders and have suitable restrictions on repayment or else have a suitable mechanism for conversion into a donation.

In order for full credit to be given to future loans, rules would usually have to be in place so that either a suitable Qard al-Hasanah would be

compulsory even following a winding-up of the operation or suitable triggers should be in place to require such loans to be made pre-winding-up. In the case of a compulsory Qard al-Hasanah, the agency would need to be confident that the compulsion would be legally effective.

■ Appendix 1 – Sample Agenda and Information Request List

The following is a sample meeting agenda to be used by Fitch when conducting its management review of Takaful firms. Fitch generally requests to meet with key individuals from the management board including the CEO/president, CFO and COO where these exist. In addition, the agency will look to meet with relevant technical experts (particularly the head actuary) where these individuals are not board members.

Corporate Overview

- Takaful firm overview and history.
- Management, ownership and organisational structure.
- Takaful business model used for Shari'ah compliance and the sharing of surplus.
- Key strategic objectives for the Takaful fund and operator.
- Financial goals and key performance indicators used internally by the Takaful operator.
- Recent developments.

Legal and Regulatory Review

- Extent to which fund participants have recourse to assets of the Takaful operator in a winding-up. Details of the expected ranking of creditors in this case.
- Details of the Qard al-Hasanah (current scale, compulsion over provision, subordination, terms of payback, circumstances under which it converts to a donation if any).
- Regulatory environment and issues.
- Applicable legal framework and other queries.

Operating and Underwriting Review

- Lines of business and mix.
- Product review and pricing targets.
- Underwriting approach and system of controls together with the ability to reprice business.
- Competitive strategies and both recent and expected changes in competitive environment.
- Distribution strategy and growth plans.
- Administration and technology review.
- Claims and expense management.
- Underwriting and operating results (historical and projected).
- Scale of rewards and fees for the Takaful operator under the business model used and basis used for calculation (eg net or gross contributions for the Wakala fee with relevant percentage).

Financial Review

- Operating performance, both for the Takaful fund (split by sub-fund/business line) and Takaful operator.
- Capitalisation of the Takaful fund and operator, including targets, strategy and measures used to assess capital adequacy.
- Current level of interest-free loans (Qard al-Hasanah) and historical movements in this balance over the last five years.
- Cash flow analysis, including payment of surplus to participants in the Takaful fund and upstream dividend strategies by the Takaful operator, if applicable.
- Financial budgets and projections for the fund and operator.

Investment and Liquidity Review

- Investment policy and portfolio mix.
- Concentration of risks within the investment fund.
- Recent results relative to benchmarks.
- Asset-liability management.
- Investments with related parties.
- Liquidity review, including both subsidiaries and holding company.
- Operating cash flow.

Reserve Review

- Methodology and adequacy analysis (quantitative measurements).
- Development trends.
- Review of any latent exposures, including asbestos and environmental.
- Relationship of reserving and pricing reviews.
- Application of discounting and discount rate applied.
- Discussion of external or internal reserve studies.

Reinsurance and Large Loss Review

- Current reinsurance programme and identity of providers.
- Changes in programme pricing.
- Security, concentration of risks and collection issues.
- Catastrophe risk, including tail value at risk and probable maximum loss analysis, if applicable and where available.

Additional Topics

- Management controls and corporate governance.
- Enterprise risk management.
- Accounting and tax issues.
- Other topics to be determined on a case-by-case basis.

## Sample Information Request

Fitch typically requests the following information on an annual basis.

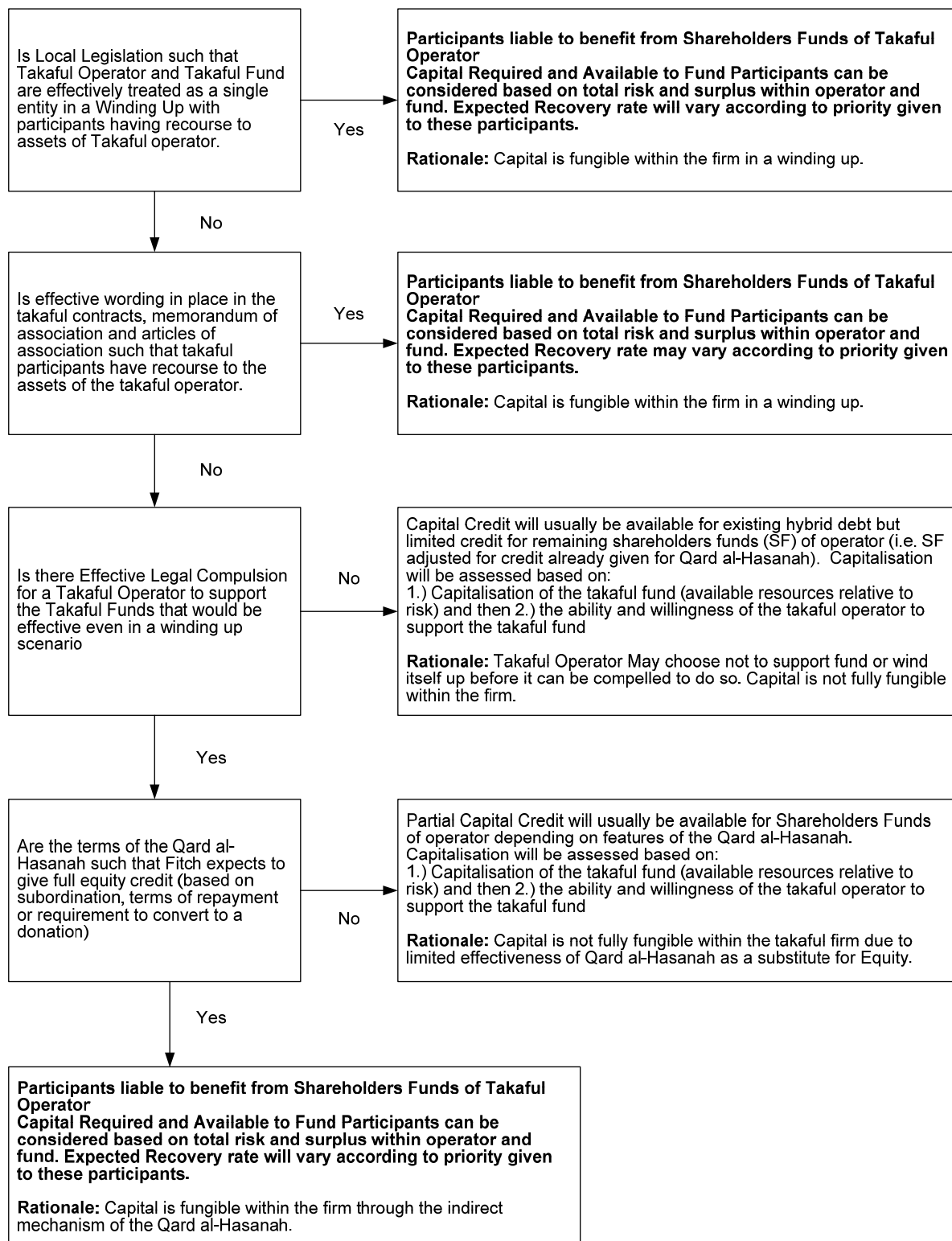
- Consolidated GAAP financial statements, including balance sheets, income statements, cash flows and notes.
- Legal documentation relating to the formation of the operator and fund (eg articles of association and memorandum of association).
- Examples of legal documentation provided to Takaful participants.
- Regulatory filings, where applicable.
- Financial projections (summary income statements, balance sheets and capital ratios).
- Independent and internal reserve appraisal reports, including narrative of process used to establish and monitor loss reserves.
- Distribution of assets by quality ranking, industry category, concentrations and other categories perceived to be important.
- Description of ceded reinsurance programmes, tail value at risk and probable maximum loss analysis, and list of major reinsurers on both current programmes and those for which there are recoverables. Details of any mandatory cessions.
- List of major distribution sources.
- Detailed description of products offered.

- Statistics on number of participants, new participants and participants that have left the Takaful fund.
- Comparison with competitors (where possible) in respect of contributions required and surpluses returned.
- Are there examples of the actual rewards and fees percentage taken by either party deviating from the agreed percentage?
- Details of any cases where the firm has been required to pay claims as a result of unclear wording.
- Listing of investment guidelines.

The following information is requested as part of the initial ratings review, with updates requested whenever material changes are made.

- Annual financial statements and regulatory returns for past five years where applicable.
- History of the company focusing on major milestones.
- Senior management biographies.
- Investment policy and guidelines.
- Organisational charts covering corporate structure and principal executive reporting lines.
- Descriptive material on each business segment, including product descriptions and strategy.

■ Appendix 2 –Example Guidelines for Demonstrating the Availability of Takaful Operator’s Assets to Takaful Participants



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