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## Are commercial pressures taking Takaful away from Mutuality

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## Cooperatives

- *Autonomous association of persons united voluntarily to meet their common **economic, social & cultural needs and aspirations** through a jointly owned **democratically – controlled** enterprise* (definition from International Cooperative Alliance)
  - common economic and social needs
  - democratically controlled
- Perfect alignment of shareholders and consumers interest as they are one and the same entity. Theoretically this should result in;
  - cheaper cost
  - better quality

## Modern Takaful - Hybrid approach (Proprietary management company combined with Mutual risk pool)

- Policyholders (termed participants) “**contract out**” administration functions to a proprietary company (the Takaful Operator, TO). Under this hybrid approach these functions are performed on behalf of the policyholders through appropriate **Sharia compliant bilateral contracts**.
- Under this approach, and for example using the Wakala (Agency) contract, the premium is first divided between the fee payable to the Company (which is paid into the shareholders account) and the *Tabbaru'* (which is paid into the Takaful risk pool).

## Modern Takaful - Hybrid approach (Proprietary management company combined with Mutual risk pool)

<b>Takaful Mutual Risk Pool outsources</b>	<b>Sharia Contract</b>	<b>Management company receives</b>
Administration, distribution, Underwriting, actuarial & finance	Wakala Contract	A fixed fee calculated as a percentage of premium or alternatively a fixed amount
Investment of Takaful Funds	Option 1: Wakala Contract	A fixed percentage of funds under management
	Option 2: Mudharabah Contract	An agreed percentage of the profits from investments

## Attraction of Takaful to participants

- No initial set up costs. Management cost overruns in the initial set up phase are borne by shareholders
- Policyholder can choose the better managed Takaful fund with appropriate service commensurate with the wakala fee payable and a good surplus refund track record
- There is transparency in the management agreement as the Takaful Operator (TO) should disclose its wakala fee structure and surplus distribution policy in the takaful contract.
- The investments of the Takaful funds would be Sharia compliant. Sharia compliant investments are compatible with Socially Responsible Investments.



## What services are being “bought” and what is being “shared” in takaful

- Contribution (i.e. premium) for Takaful is determined as the sum of the risk premium and the wakala or agency fee. For family (or life) takaful there may also be a savings component.
- Thus, other than the expected claims outgo, distribution and admin services are being **bought** from the takaful operator through the agency fee.
- Expected claims outgo as defined by the risk premium are an estimate and does not represent the final cost of risk. In a takaful fund risk is being **shared** rather than sold. The ultimate cost of risk in the year is equal to the actual claims incurred in the year.



## How can takaful “lose” its mutuality

- Pure risk versus speculative risk
  - The insured buys insurance to protect against an event that can only result in a loss to the insured. The insured cannot gain from the calamity should it happen he can only lose. This risk is categorized as *Pure Risk* as long as the compensation payable as a result of the loss only covers the monetary equivalent of the loss.
  - The insurer takes on the risk in the expectation that at the end of the term of insurance he may or may not have to make a claim payment. Over the period if the total risk premiums received exceeds the claims incurred he makes an underwriting profit, otherwise he makes an underwriting loss. This is term *Speculative Risk*.



## How can takaful “lose” its mutuality

- **Proprietary insurers trade in risk.** They take pure risk which vests in the insured in exchange for a premium. Through this process they undertake speculative risk. This is different from commerce to the extent that the insurer has no influence on the outcome of the risk undertaken.
- The insured is “guaranteed” a payout on the occurrence of the insured contingent **as long as the insurer is solvent.** In many jurisdiction this guarantee is backed indirectly by the insurance industry as a whole or sometimes even the government.



## How can takaful “lose” its mutuality

- **Such guarantees are not “free”**
- The insurer requires capital to finance the guarantee. It has to “service” this capital. It may contribute to an industry guarantee fund. Finally there is the government (*It cost money to lobby for a bail out!*).
- The insurer may also purchase matching bonds to ensure payment of claims. As long as the bonds do not default the claims are secured. In such instances the cost of guarantee is part of the purchase price of the bonds.



## How can takaful “lose” its mutuality

- Can takaful “match” these guarantees?
  - The concept of mutuality espouses the spirit of solidarity and that of mutual (read limited) guarantee; limited to the resources of the risk pool.
  - Spreading the risk through appropriate retakaful arrangements may strengthen the certainty of meeting claims obligation.
  - Then there is the Qard Hasan (interest free loan) from the TO. This involves spreading the risk over time.
  - It is worthwhile to note that there are no (?) Sharia compliant investments available to hedge a fixed monetary obligation.



## How can takaful “lose” its mutuality

- Where takaful products are guaranteed by the TO, it loses its mutuality
- Where the investments of the Takaful company invests in assets which provides guaranteed returns, it loses its mutuality
- Where the takaful fund take reinsurance rather than retakaful, it loses its mutuality



## Should we look to takaful for guarantees?

- The concept of risk sharing rather than risk transfer is fundamental to *Fiqh Muamalat* (jurisprudence governing transactions, i.e. bilateral contracts). This is reflected in the prohibition of *riba*, *gharar* and *maysir* (prohibition of interest, elements of uncertainty in any bilateral contract and gambling). If we accept these principles then there cannot be any compensation for the undertaking of risk, thus no “buying” of guarantees, and thus no monetary guarantees are possible in takaful.
- With the absence of guarantees can takaful compete with conventional insurers?



## Guarantees are overrated

- Ultimately there are no guarantees in life notwithstanding what the rating agencies may choose to say...
- Look at AIG and the experience with variable annuities in the US with the likes of Ameriprise Financial Inc., Prudential Financial Inc., Allstate Corp., Hartford Financial Group and Lincoln National Corp. all may have to be bailed out by the US government.
- Takaful needs product differentiation not compete on guarantees.



## Should takaful be “cheaper” than conventional insurance?

- Unfortunately many takaful companies are small or new, thus lacking in critical size. There are also additional layers of corporate governance in takaful which needs to be funded. Retakaful support may also be “expensive” compared to reinsurance. All these tend to weigh down on the competitiveness of takaful as compared to conventional insurance.



## Has the takaful industry contributed to the “blurring” of mutuality?

- Insufficient product differentiation.
  - This is “*halal*” while this is “*haram*”, the price is the same. Choose...
- Lack of education to the market as to the difference between takaful and conventional. If you do not understand the reason why it costs more you are unlikely to accept a higher “price”.
- Sharing of a common distribution channel with conventional insurance without product differentiation can also result in compromises in mutuality.



## Has the takaful industry contributed to the “blurring” of mutuality?

- Competition among takaful operators based purely on price results in commoditizing the product, resulting in inadequate risk premium and potential underwriting deficit.
  - At the extreme the TO may be pushed towards “cash underwriting”, basically top line driven which would maximise its agency fees with no consideration of the downside on the basis that underwriting losses are for the account of the takaful mutual fund only.
- Protective Regulators may insist in TO guaranteeing benefit payouts resulting in TO’s having to increase its wakala fees to compensate.



## How can takaful compete?

- Product differentiation
- Education of the public on the differences between takaful and conventional insurance
- Regulatory recognition of the mutuality of its operation which should result in lower solvency requirement and thus “cheaper” products
- Separation of distribution channel from conventional insurance



## Finally, learn from the experience of demutualisation...

- Why have Mutual Insurer's demutualise?
- Capital for expansion. No success story so far..
- For profit (to members)
  - “windfall” payout
  - Expectation of capital appreciation on equity
- Management failure to engage their members in the business which are supposed to be member owned.

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