Developing a Takaful product in India – Risks and Challenges

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Objective

Being aware of the fact that papers on Takaful tend to focus either on introducing the fundamental laws for Takaful as expounded in the Shariah or on Takaful models, the objective of this paper was set firstly, to provide a useful reference material for Indian insurers on Takaful and the experience in other countries; secondly, to provide insights into business potential in India and challenges that insurers might face and thirdly, to put the first step forward in developing a roadmap for Takaful market development in India.

Abstract

This paper deals with the principles and practices of Islamic Insurance and the risks and challenges that Indian insurers might have to face when they plan to launch a Takaful product. It briefly touches on the regulatory issues and concerns regarding developing, regulating and supervising a Takaful market. The first section*, **Takaful principles and practices**,* provides a primer on practical aspects of Takaful products and available models. It also provides a market and a regulatory overview in nine countries where Takaful products are available. The second section, ***Risks and Challenges**,* deals with the possible areas which might pose challenges and an opportunities to an insurer who wishes to launch a product in this line of business. The third section, ***Specific issues for India***, provides a roadmap for market development based on the Malaysian model as well as an insight into the Muslim demography in India to determine the market potential along with a quick look at the mortality differentials between Muslim population in India as compared to the total population mortality. The final section lists a few ***Takaful Interest Groups***.

Section 1

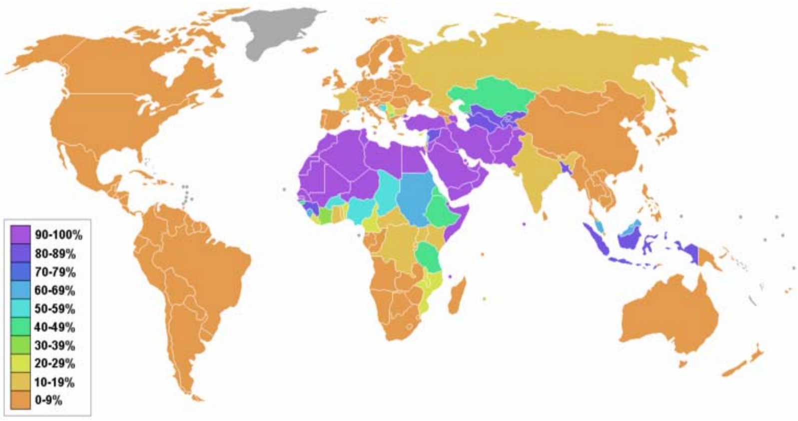
1 Takaful Principles and Practices

This chapter looks into the principles and practises of Islamic insurance, commonly referred to as takaful. After outlining why conventional insurance is prohibited under Islam, an alternative insurance model will be presented that is in line with the Islamic law, or Shariah. This is followed by a detailed description and analysis of the various operational takaful models, before an overview of the current takaful market is given to get a grasp of how the various models are applied in practise. The last section zooms in on the challenges ahead for new takaful operators and what key factors have to be taken into account in the initial set-up.

The focus of this chapter will be on practical aspects and less so on Shariah issues as there is no common global standard for many Shariah matters. Such issues are handled differently depending on the country or region and it is outside of the scope of this paper to delve too into Shariah subtleties. What is presented here can be regarded as the "mainstream" view on takaful, if there is such a thing.

1.1 The Rise of Islamic Insurance

Figure 1: Muslim percentage of population by country



The Islamic world accounts for a quarter of the world population, but is only contributing to about 5% of global insurance premium. Efforts to offer insurance products to this market being compliant with the Islamic law have gained particular momentum in the last few years. Principles and practice of takaful are still evolving, but have already led to respective rulings of leading Islamic scholars and takaful regulations in countries such as Malaysia, Pakistan, Bahrain and Saudi Arabia.

Shariah compliant takaful operators have been set up both in Muslim dominated countries but also in countries where Muslims are a minority. For the year 2015 forecasters predict between US$7-10 billion takaful premiums up from currently about US$3 billion. Both demand and supply of Shariah compliant insurance and reinsurance is developing with increasing dynamic, following in the footsteps of the highly successful Islamic Banking and Finance market.

As impressive as the growth of takaful has been over the last few years it has to be acknowledged that it is a market in its infancy and thus small compared to the global insurance market – total takaful contributions make up less than 1‰ of the global insurance premiums. But the potential for takaful is enormous and lies first and foremost in the Muslim world, which is by and large underinsured.

1.2 Takaful Primer

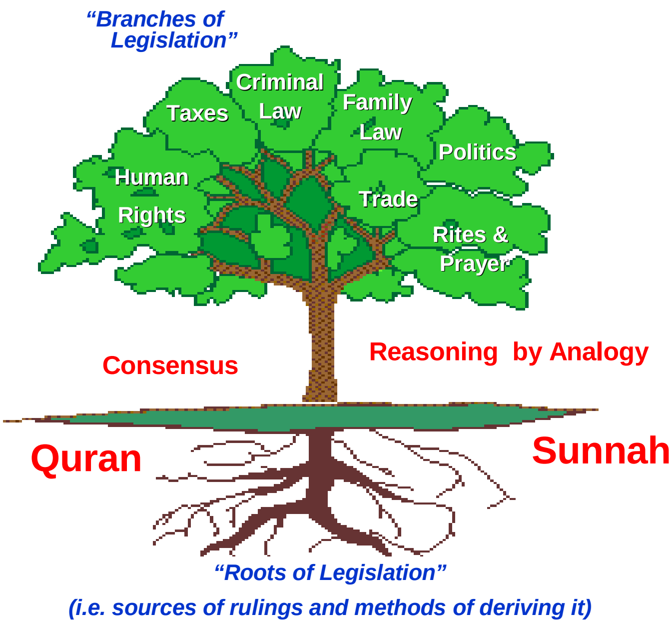
As takaful is a new concept to many, it is crucial to understand the basic mechanics, specifics and differences to conventional insurance. For the purpose of this paper we do only assume a very basic understanding of takaful. For ease of reference the readers might also refer to the *Takaful Lingo* for better understanding of takaful terms used throughout the document.

Takaful Lingo			
Takaful	***Conventional Pendant/Translation***	***Takaful***	***Conventional Pendant/Translation***
Aqad	*Contract*	*Operator*	*Insurer*
Contribution	*Premium under Takaful*	*Participant*	*Policyholder*
Family Takaful/ Ta'awuni	*Islamic Life Insurance*	*Qard al Hasan*	*Interest free loan*
General Takaful	*Islamic Non-life Insurance*	*Ujrah*	*Fee*
Hala/Haram	*Lawful/Unlawful under Shariah*	*Sum Covered /Takaful Benefit*	*Sum Assured*
Hibah	*Gift*	*Nominee*	*Wasi*

The Shariah

Shariah refers to the Islamic law and governs all aspects of both personal religious practice and Muslim society at large as shown in the *tree analogy*. It can also be seen as a code of best conduct regarding all ways of life. Its essence is derived from the holy book - the Quran - and the Sunnah. According to Muslim tradition, the Quran was revealed in Arabic to the Prophet Mohammad (*saw*) by God through the agency of the angel Gabriel. The Sunnah refers to the sayings and actions of or approved by Prophet (*saw*) as an example of life for every Muslim.

The Quran and the Sunnah have been compiled more than 1.000 years ago. They cannot be changed, but the independent reasoning of the Shariah scholars (Islamic jurists) can be revoked or adapted to changing circumstances: New developments (such as birth control, human cloning, organ transplant or commercial matters like credit cards or takaful) not directly mentioned in the Quran or Sunnah are dealt with under the Shariah by way of legal reasoning and judgment of reputable Shariah scholars. Once a consensus has been found in the consultation process a fatwa (religious ruling) on the subject at hand becomes part of the Shariah. It can thus be considered as a kind of case law. A pluralism of cases or *fatwas*, sometimes even contradicting each other, is an integral element in the Islamic law. It has to be noted that such interpretations can vary widely amongst scholars or regions and a fatwa does not automatically become applicable to all Muslims in the world. This fact has lead to different models of takaful as discussed below and is an obstacle towards standardization.



1.2.1 Risk Management under Islam

There is a common misperception that insurance or risk mitigation is not allowed under Islam, as Muslims believe that only God knows one's future and faith. But the following conversation taken from the sayings of the Prophet Muhammad (saw) depicts a beautiful message as to why Muslims should indeed reduce the risk of loss:

Prophet Muhammad (saw) asked a Bedouin who had left his camel untied, "Why do not tie your camel?" the Bedouin answered, "I put my trust in God" the prophet then said, "tie up your camel first then put your trust in God".

1.2.2 Why is Conventional Insurance Unlawful?

So if the Islam does indeed support and encourage the management of risks, one might rightly ask why conventional insurance is not allowed. There have been many rulings by Islamic scholars stating that conventional insurance as currently practiced is unlawful under Islam as it contains elements prohibited under the Shariah:

- **Riba:** Paying or receiving interest

- **Gharar:** Excessive uncertainty in a contract
- **Maisir:** Gambling
- **Haram:** Investment in prohibited assets

1.2.3 Riba

Paying and/or receiving interest is not permissible; in insurance companies this refers to the investment side (e.g. investments in fixed interest rate assets like deposits or bonds) as well as to the liability side (e.g. interests on policy loans). Riba is strongly condemned by the Quran and Sunnah. This may sound strange to people unfamiliar with Islamic Finance at first as interest is a crucial element of the conventional financial system. Monetary capital is treated on par with production factors like land or labor, each being entitled to a return (rent, salary) regardless of profit or loss. But one has to understand that a key principal of the Islamic financial system is that any profit from trade and business has to come along with a liability or risk. Money capital in Islamic finance is here seen as on par with an enterprise which comes with both risks and rewards.

As is often the case under Shariah different interpretations exist and a few Shariah scholars have challenged this strict interpretation of riba and argue that only excessive commercial interest is prohibited (e.g. charged by loan sharks). But the general view is that any form of interest is prohibited under the Shariah, both a reasonable and an excessive one.

1.2.3.1 Gharar

Gharar means that it is not acceptable in contract arrangements to make payments conditional upon the outcome of an uncertain event. One may think of "selling the fish in the water" or the fruits on the trees at the beginning of the season. It may result in the unjustifiable disadvantage/loss of one party and equally undue enrichment of the other. Gharar is forbidden to ensure full consent and satisfaction of the parties in a contractual agreement. This can only be achieved through certainty, full knowledge, disclosure and transparency.

Unlike riba, which makes any business transaction prohibited, it is understood that uncertainty cannot be totally avoided in any business; it is excessive uncertainty that is prohibited.

The uncertainty in insurance is that both timing and amount of the insured event are unknown at inception of the policy. Opinions vary on whether this uncertainty can classified as excessive, taking into account that the policyholder is informed about this condition black on white in his policy conditions. Excessive uncertainty could rather be linked to the "fine-print" in policy wordings, which have haunted the reputation of insurance companies ever since. But regulators in developed countries have taken a stronger stance towards unclear wordings and marketing material. For instance the Financial Services Authority (FSA) in the UK requires "plain English" in the policy terms.

1.2.3.2 Maisir

Gambling is a form of Gharar and conventional insurance is regarded as a kind of gambling as the insured makes a bet on the loss occurrence and the same applies vice versa for the insurer. It is also regarded as acquiring wealth on luck or by chance and at the cost of others.

The reasoning is sound and comprehensible, but a common counterargument refers to the fact that insurance is not meant to provide windfall gains, but rather indemnify the insured/beneficiary in case of an insured event. Non-life insurance is based on indemnification and does somehow stand *the 'maisir test', unlike life insurance, where the amount of indemnification (sum assured) can be a rather subjective matter and open to windfall gains. To prevent such financial windfalls, life insurers do so-called financial underwriting to check whether there is an insurable interest and whether the insured amount is in line with his actual financial needs and not excessive.*

1.2.3.3 Haram

Conventional insurers sometimes invest in assets that are strictly forbidden by the Shariah: Certain commodities such as alcohol, gambling or pork are forbidden, as are any associated activities/investments.

1.2.3.4 Conclusion

The discussions on whether or not conventional insurance is in line with the Shariah are manifold but the widely accepted view is that conventional insurance is unlawful. This was stressed by *The Islamic Fiqh Academy*, which stated in the '*Resolution No 9 Concerning Insurance and Reinsurance'* (Jeddah/KSA 1985):

> *"First: The Commercial Insurance Contract, with a fixed periodical premium, which is commonly used by commercial insurance companies, is a contract, which contains major element of risk, which voids the contract and, therefore, is prohibited (Haram) according to the Shari'a* "

The Islamic Fiqh Academy is the highest authority in Islamic jurisprudence matters, though its resolutions are not binding. But recognising that the academy is a subsidiary organ of the Organization of Islamic Conference it becomes clear that its resolutions do have a strong impact on Shariah issues.

It is not within the scope of this paper to delve too deep into Shariah details, but it should be mentioned here that other schools of thought exist on insurance. Some scholars argue that insurance is allowed as long as it does not involve riba. Then there is another group condemning life insurance but accepting non-life insurance for the reasons mentioned before.

1.2.3.5 A Shariah Compliant Alternative to Insurance

Knowing what makes insurance unlawful immediately raises the question whether there is any alternative form of risk management in line with the Shariah. There have indeed been many meetings and resolutions on insurance and alternative forms of risk management, one important being by the *Islamic Fiqh Academy,* which provided in the above mentioned '*Resolution No 9 Concerning Insurance and Reinsurance'* an alternative construct to overcome the aforementioned obstacles:

> "*Second: The alternative contract, which conforms, to the principles of Islamic dealings is the contract of co-operative insurance, which is founded on the basis of charity and co-operation. Similarly is the case of re-insurance based on the principles of co-operative insurance."*

Hence an alternative form of contract was found and Takaful can thus be seen as the Islamic counterpart of conventional insurance, i.e. insurance compliant with the Shariah. Takaful is not a type of insurance but rather an alternative to insurance. It has to operate on cooperative principles and incorporate the concept of *tabarru* (donation, gift). Instead of paying an insurance premium, takaful participants (policyholders) donate their takaful contribution to a common pool to mutually assist the members against a defined loss or damage. It is a kind of a one-way transaction, unlike in a bilateral conventional insurance contract, where a premium is paid in return for an insurance benefit.

The pooling does eliminate *gharar*, as the uncertainty about future claims events is certainly still existent but acceptable as the tabarru is meant for mutual assistance and not for profit taking or gambling (contracts of charity are not affected by the prohibition of gharar). Donations also allow participants to achieve self-purification and peace of mind.

Unlike in conventional insurance where the risk is transferred to the insurer, all participants mutually share the risk and it is important to note this very difference to conventional insurance. This explains the term *takaful* which originates from the Arabic verb *kafalah*, to guarantee, and can also be translated as mutual or joint guarantee. Family takaful is also known as Ta'awuni in Saudi-Arabia.

What is further present in takaful (and in Islam in general) are moral values and ethics - business is meant to be conducted openly in accordance with utmost good faith, honesty, full disclosure, truthfulness and fairness in all dealings. The same is certainly expected of insurance operations, but generally speaking the aim of takaful is to operate on more ethical principals.

1.3 *Takaful Operation*

The alternative contract as outlined above requires further clarification as to how exactly a takaful contract is designed, what parties are involved and how a takaful operation is set up.

Under takaful, all participants agree to pay their tabarru and mutually help each in case of a misfortune under cooperative insurance, basically referring to a pooling arrangement. It is apparent that such a pool should not be run and administered on a bigger scale by non-professionals or volunteers due to its complexity and expertise required. Therefore a mandate is given to a takaful operator to do exactly this job. The takaful operator can be run as a non-profit or for-profit organization. Mutual companies or cooperatives are examples for the former and can be found for instance in the Sudan or Saudi Arabia. But commercial takaful operators managing the takaful fund on the participants' behalf are far more widespread globally. In that case, the takaful operator is authorized by the participants with managing the risk and investment business of the participants. This comprises all operational areas such as pricing, valuation, distribution, acquisition, underwriting, claims handling, investment and asset management, accounting as well as the arrangement of retakaful (Islamic reinsurance). For carrying out these administrative tasks the takaful operator receives fee-based compensation or a share of the generated profits from the participants, the basis of which differs, depending on the respective takaful model as outlined below.

It is apparent that a takaful operation has to be in line with the Shariah, in each and every aspect, otherwise every mutual/cooperative would also be a takaful company. For instance, a takaful also has to avoid interest bearing and haram investments, which basically means that all investments have to be in Islamic financial instruments. Another aspect is the high degree of disclosure and transparency required under the Shariah. Hence, every takaful operator has to establish a Shariah Advisory or Supervisory Board of qualified Shariah scholars to ensure Shariah compliancy of the operation at all times.

The overall structure of a takaful set up comprises thus of three parties, participants (policyholders), operator and Shariah board as shown below and we will examine in the following the relationships, duties and obligations:

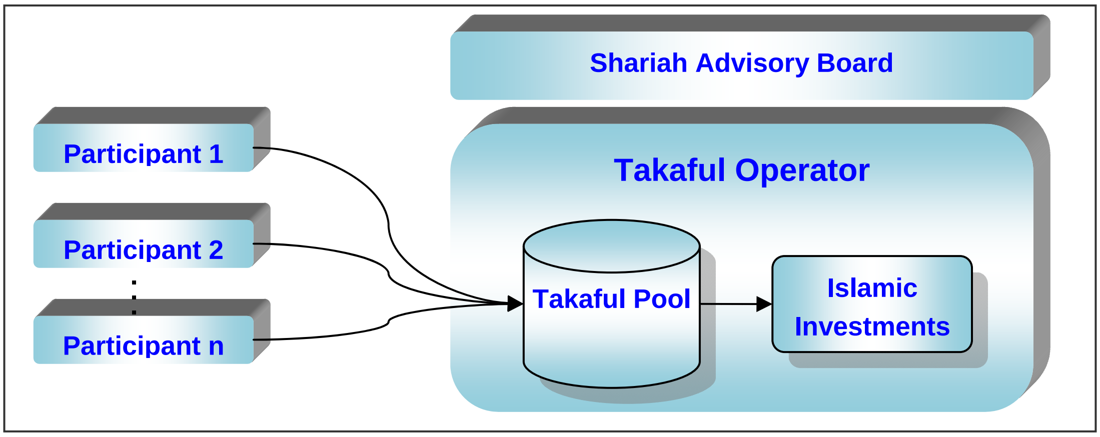


Figure 2: Parties involved in Takaful

1.3.1 Takaful Operational Models

There are several forms of contracts/models that govern the relationship between the participants and the takaful operator. The main issues are basically:

- Who pays for the expenses incurred in the business venture?
- How are profits of the underwriting and the investment part shared between the parties?
- Who is liable for any losses arising from the venture?
- Who does provide the capital to set up the operation?

The models most commonly used for operating a takaful fund are based on the Shariah concepts of wakalah and mudharabah or a combination thereof:

Basic concept of Wakalah: Wakalah is an Islamic form of contract, in which an agent is authorized to act on behalf of a principal and to carry out a predefined business against a fee. This fee may be pre-agreed as an *absolute figure* or as a *percentage of the turnover*, but usually not as a share of the profits of the venture. ➔ Wakalah is often interpreted as a fee driven Islamic contract.
Basic concept of Mudharabah: Mudharabah is a form of contract, in which one partner provides his work and the other partner provides capital. Both shared the profits of the joint venture by a pre-defined ratio. ➔Mudharabah is often interpreted as a profit sharing Islamic contract.

Segregated Funds

We will see in the following how these contracts are applied to takaful. The split of the insurance business into administration/asset-management and risk-carrying function obliges the takaful operator to maintain strictly segregated funds. One fund is for the equity of the shareholders' of the takaful operator, i.e. the shareholders' fund and the other for the contributions of the participants (policyholders):

- Shareholders' Fund
- Participants' Risk Account (PRF): it works on the basis of mutual help, where all participants sign a contract (aqad) to participate and to fulfil their obligation in the form of contribution (tabarru) to mutually help other participants who suffer a misfortune. The PRF may sometimes also be referred to as simply takaful fund. There can be more than one risk fund, e.g. distinguished by line of business (individual family, group family, investment linked, annuities etc).

For savings/investment type family takaful products there is a need for at least another additional fund:

- Participant's Investment Account (PIA): The other part of the contribution is placed in another fund for savings and investment, invested by the takaful operator. This fund is not mutual in nature but is rather the sole and exclusive property of the individual who participates in a family takaful contract. This fund is also used for regular or single premium contracts where the tabarru charges are "dripped" on a regular basis (e.g. monthly or yearly) from the IPA to the PRF (also see 1.2.1.14 Dripping Concept). One might notice the similarities to a unit-linked insurance construct.

Takaful Benefits

- The takaful benefit on claim is the sum covered plus the amount accumulated in the PIA and a proportional share of the surplus in the takaful fund on termination of the contract.
- On surrender usually the amount in the PIA minus a surrender charge is paid out.
- On maturity the PIA amount plus

Surplus Sharing

Surplus arising from the participants' funds will usually be distributed to participants (usually to the PIA where it accumulates) and, depending on the takaful model, also shared with the takaful operator. Surplus from the risk fund may also be donated to charities selected by the operator's Shariah Advisory Board. It is common to build up a claims contingency reserve within the risk fund from past underwriting surplus to act as a buffer for an adverse claims experience (see 0).
The surplus distributed to participants is usually proportional to the contributions to the PRF net of any claims, which they may have received during the valuation period.

1.3.1.1 Mutual/Cooperative, For-Profit Insurance Company

Before describing the various takaful models a brief overview is given of a mutual and a conventional insurance companies for better understanding and comparison. As most readers should be fairly familiar with such operations, no further analysis is provided here, but pros and cons will be discussed in some details in section 2.1 *2.1 Legal* Structure below.

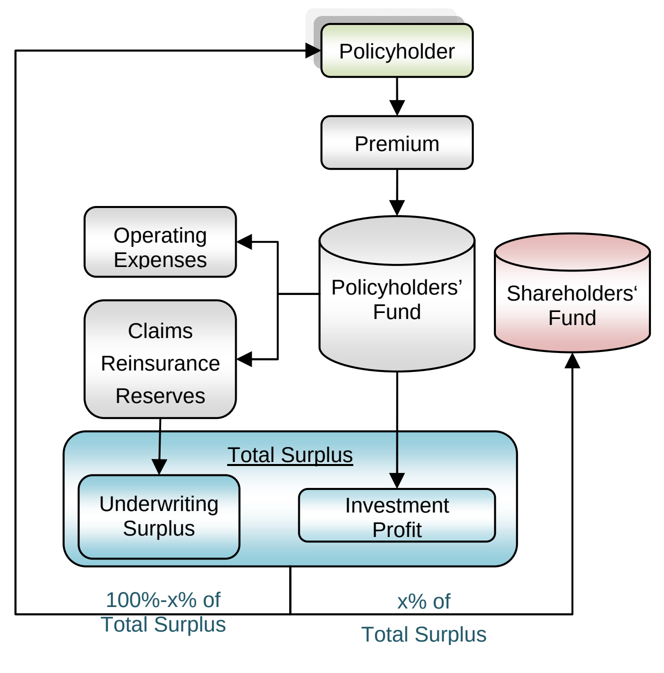


Figure 3: For-Profit Insurance Company

The total profit is shared between the insurer (x%) and the policyholders, such as 90/10 for with-profits life insurance or 100/0 for non-participating business.

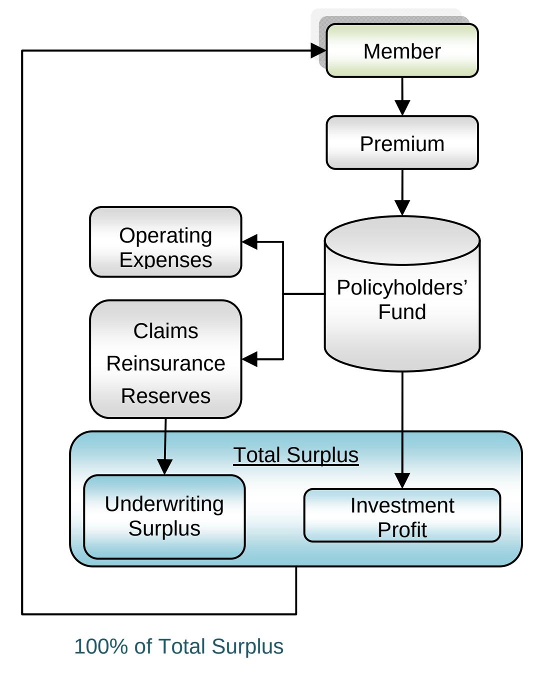


Figure 4: Co-operative/Mutual

Profit belongs to the members as owners of the fund and is distributed to the members or retained within the fund. In practice though, if run by an operator, the surplus might be shared.

1.3.1.2 Pure Wakalah Model

Under the **pure wakalah** or agency model, the takaful operator acts as the agent and administers the fund(s) on behalf of the participants, thereby ensuring adequacy, equity and fairness among all participants. In return he receives a pre-agreed and upfront wakalah or administration fee to cover the operating expenses usually also inclusive of distributors' commission, but he does not per se share in the underwriting or investment profits. One may think of the takaful operators as being a mere third-party administrator. The drawing below outlines the overall workflow in a simplified way:

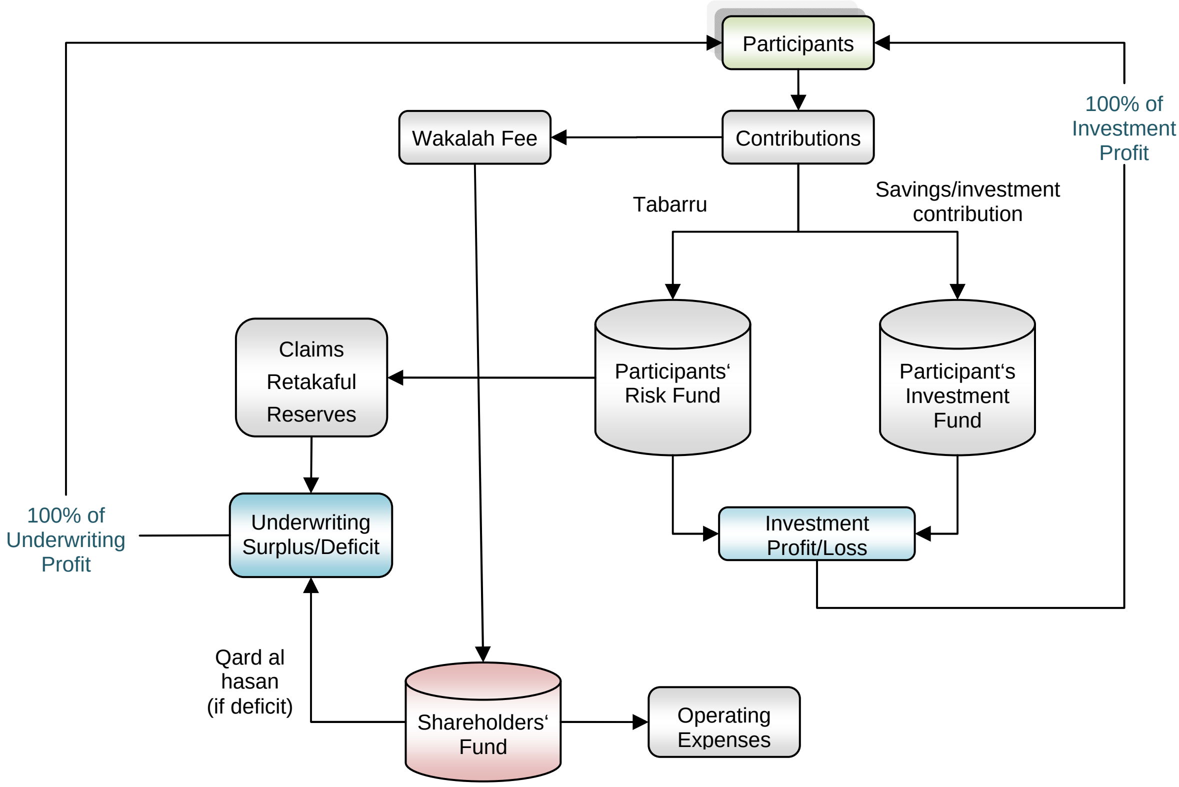


Figure 5: Pure Wakalah Model

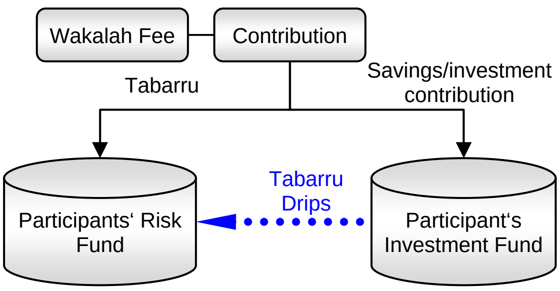
- The net contribution after deduction of the upfront wakalah fee is split into the tabarru for the mortality/morbidity risk and the savings/investment:
- The Participants' Risk Account (PRA) is a mutual pool out of which claims, retakaful and reserves adjustments are paid.
- The other part of the takaful contribution is placed in the Participant's Investment Account (PIA) for savings and investment (also see *1.3.1.3 Dripping* below).
- The PIA and excess in the PRF are invested in Shariah compliant assets.
- Any underwriting and investment surplus arising is fully distributed to the participants.
- In case of a underwriting deficit, e.g. due to adverse claims experience, the operator is usually obliged to make up for the deficit and provide a so-called qard al hasan or interest free loan. This loan will be repaid out of future surplus arising, though both timing and amount are uncertain.

The wakalah fee is typically a fixed percentage of the takaful contribution and an additional fee for the fund investment as a percentage of the fund value of the PIA. This guarantees the operator a steady fee-based income, but there is no upside potential as he does not share in any profits.

Theoretically the takaful operator bears no insurance risks itself: The risk bearing is seen as a process of solidarity between participants and takes place solely among the collective of insured persons (therefore the name "joint guarantee"). But due to the obligation to make up for any underwriting losses in the takaful fund the insurer is indeed exposed to a non-negligible insurance risk: He might not be able to recuperate a qard al hasan if not sufficient surplus is generated over time. Furthermore, no interest can be charged on the outstanding loan, but this is one of the very intrinsic principles of Islamic finance that have to be strictly followed!

1.3.1.3 Dripping

One might wonder how the workflow is for regular or single premium business, because tabarru charges are usually only applied monthly or yearly. In Malaysia, a so-called 'dripping' concept is usually applied:



That is, contributions after wakalah fee are first deposited in the Participant's Investment Fund. This is maintained for each individual participant and funds are invested by the takaful operator. The participants agree at the outset to transfer from this account agreed amounts periodically being his tabarru contribution to the takaful account.

1.3.1.4 Wakalah Model with Incentive Compensation

Critics of the pure wakalah model cite the lack of incentives for the operator to properly run the takaful fund as he does not share in any profits. As his income is a fee based on turnover (i.e. takaful contributions) he might be tempted to write as much business as possible without proper underwriting or claims handling. Therefore some operators applied a *wakalah model with incentive compensation*, where the wakalah fee was adjusted (upwards) in case of an underwriting and investment surplus.

This practice is widely practiced (e.g. approved by National Shariah Council of Malaysia) but not acceptable to all scholars and practitioners for two reasons: Firstly, the operator does profit from underwriting surplus but is not responsible for losses - unlike the participants - which indicates a skewed and inequitable system. Secondly, and bearing more weight is the general reservation of many Shariah scholars towards a sharing of underwriting surplus originating from donations.

1.3.1.5 Mudharabah Model

The mudharabah model is based on classic profit sharing principles, i.e. a partnership model where the participants provide the capital, while the takaful operator provides expertise and management of the takaful fund. A contract details how underwriting surplus and investment profits are shared between operator and participants, very much like in conventional insurance (with-profits or participating business).

As mentioned before there are strong reservations among Shariah scholars about the sharing of the underwriting profit with the operator as it stems from donations. The sharing in underwriting surplus itself is something which is similar to making this into a business venture and not a mutual contract for assistance and protection. It would imply that the tabarru is working capital, which is arguably not in the spirit of a donation.

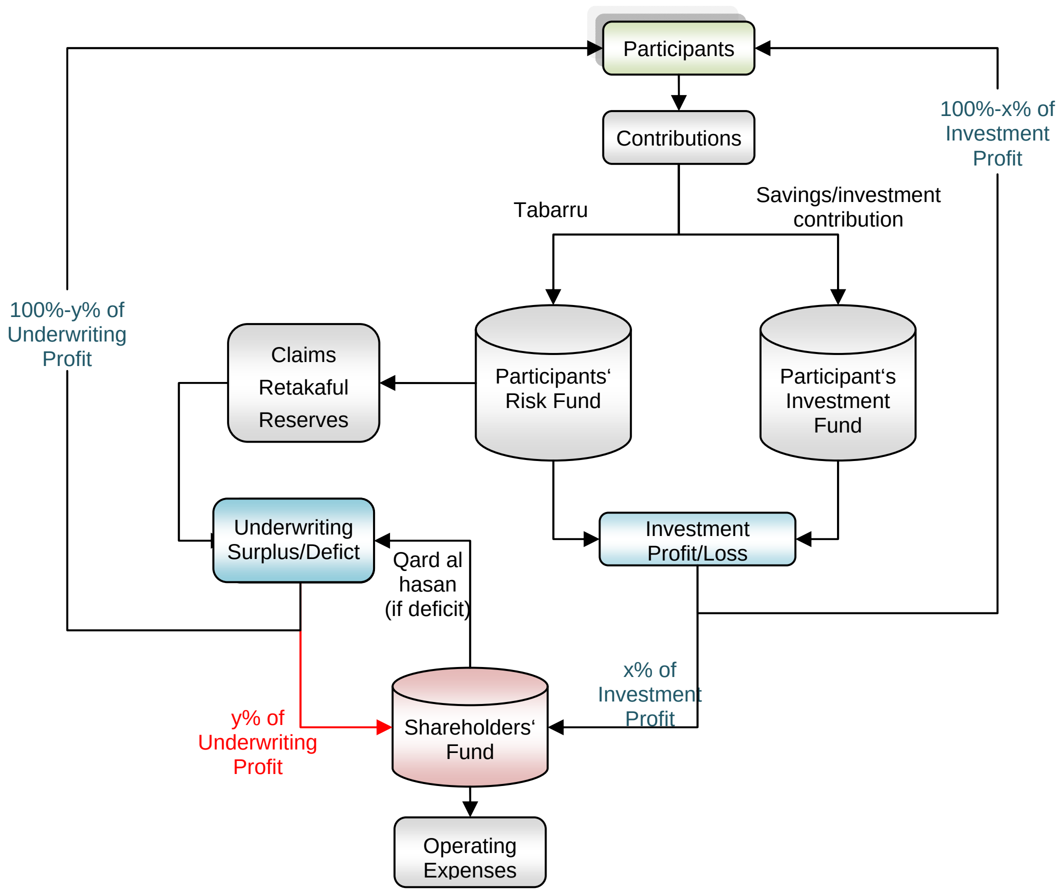


Figure 6: Mudharabah Model

A variant of this model would be that the profit sharing is only applied to the investment portion, which would be fully in line with the Shariah. But this model it might not be commercially viable as not enough income is likely to be generated from the investment portion for the takaful operator.

Another variant of this model would charge operating expenses directly from the takaful fund instead of funding it from the shareholders' fund. I.e. the underwriting result is the net of tabarru, claims, retakaful, reserve adjustments and operating expenses. An area of concern is the type and amount of expenses charged to the fund and it follows that it should be laid out to the participants in a transparent manner.

1.3.1.6 Wakalah Mudharabah Model

A **combination** of both models is common, where a wakalah applied on underwriting and a mudharabah on the investment profit for family takaful products. That is, the operator charges a wakalah fee from the takaful contribution and all underwriting profits are distributed to the participants. But investment profit is shared between participants and operator based on a pre-agreed ratio.

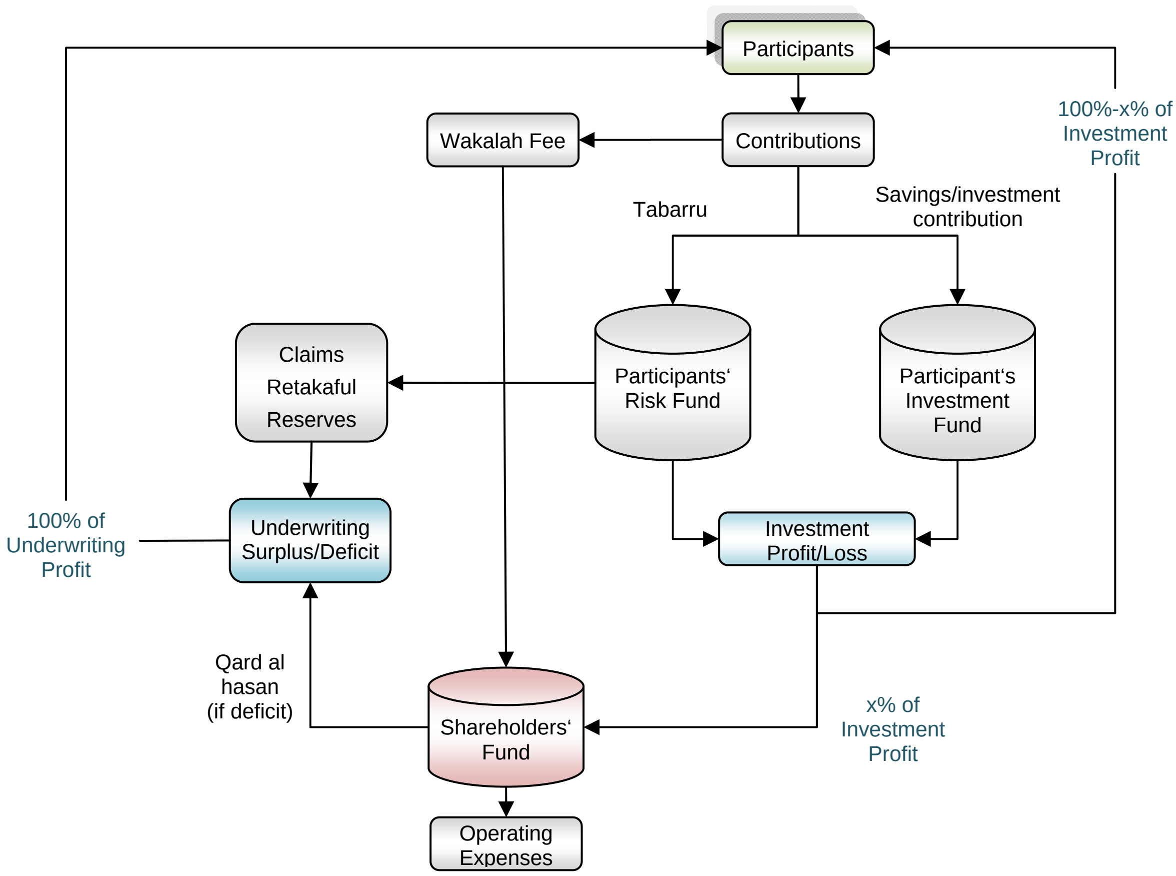


Figure 7: Wakalah Mudharabah Model

This model has its appeal as investment profits are usually the major source of income; underwriting results can easily be managed using quota share retakaful arrangements. One might argue though that "cherry-picking" is applied by mixing two different types of contracts.

1.3.1.7 Wakalah Waqf Model

The relationship of the takaful operator with the participants is rather loose and indirect, because no single participant is liable for e.g. repaying the outstanding loan or remaining in the collective until losses can be recovered. Pakistani scholars developed the idea to use a hybrid wakalah-waqf concept to remedy some of the inherent disadvantages of the above mentioned operational models (also refer to *1.3.1.14*
Ownership of the Takaful Fund and *1.3.1.14 Qard al Hasan*):

- *Shariah-related/juristic:* It is difficult to formally define the rights and obligations of the participants in Shariah terms under the pretext of the contribution being a contingent gift and no payment and the fact that the takaful fund is "owned" by the participants, which are not a separate legal entity as such.
- *Technical:* The possibility of insufficient contingency reserves in the takaful fund which increases the probability of interest-free loans given by the shareholders' fund with all the problems involved in the recovery (e.g. intergenerational unfairness).

Generally, a waqf is a pious endowment (i.e. kind of a trust), set up for an unlimited period for a group of beneficiaries defined by the trustor. In some regions, namely the Indian sub-continent, waqf was used to make agricultural property indivisible heritage by naming the trustees offspring as beneficiaries.

The main idea of this model is setting up the participants' fund like a normal wakalah mudharabah model as described above, with the only difference being that the shareholders' have to inject initial capital into the waqf fund. This would solve both problems outlined above:

- *Shariah-related/juristic:* The formal difficulties were dissolved, as a waqf fund is a separate legal Shariah entity with the right of ownership (comparable to a juristic person). Thus it can become full proprietor of the funds handed over by the shareholders and of the contributions paid by the participants.
- *Technical:* The fund itself would also contain the contingency reserves (the injected capital) and thus substantially reducing the need for interest-free loans.

However, while numerous problems related to Shariah terms could be solved this way, it is not clear whether the concept of waqf can be generalized and widened to serve as a substitute for the western concept of a juristic person (which does not exist in the Shariah).

The draft regulations in Pakistan include the waqf concept but do not explicitly mention waqf as such; the waqf concept is also used in South-Africa.

1.3.1.8 Retakaful Models

Retakaful, or Islamic reinsurance, can principally operate on the same models as described above. A retakaful model copies the essential elements of the takaful concept, i.e. a joint guarantee whereby a group of companies (instead of policyholders/participants in a direct takaful arrangement) agrees on a concept of mutual protection.

The participating takaful operators transfer their underlying risks into the retakaful pool in return for paying a retakaful contribution out of their takaful fund. The positive result of the combined fund would ultimately be redistributed to its members i.e. the retakaful contribution would by paid out of the takaful fund of the operator and any surplus from the retakaful has to be allocated to the takaful fund.

The retakaful operator would operate the fund and administer the assets on a Shariah-compliant basis. He would further ensure that all the cedants in the pool comply with the standard risk management guidelines in terms of underwriting and claims management practices.

The retakaful would finally have to provide a qard al hasan in case the reinsurance fund shows a deficit – but not in case one of the direct takaful funds is in need of a loan.
The choice of the retakaful model is of high importance for retakaful operators who need to write international business to ensure that the retakaful pool reaches its critical mass. Thus, a wakalah model is the preferred model to warrant regional or even global Shariah compliancy.
For pure risk-premium basis business the simplified model would thus look as follows:

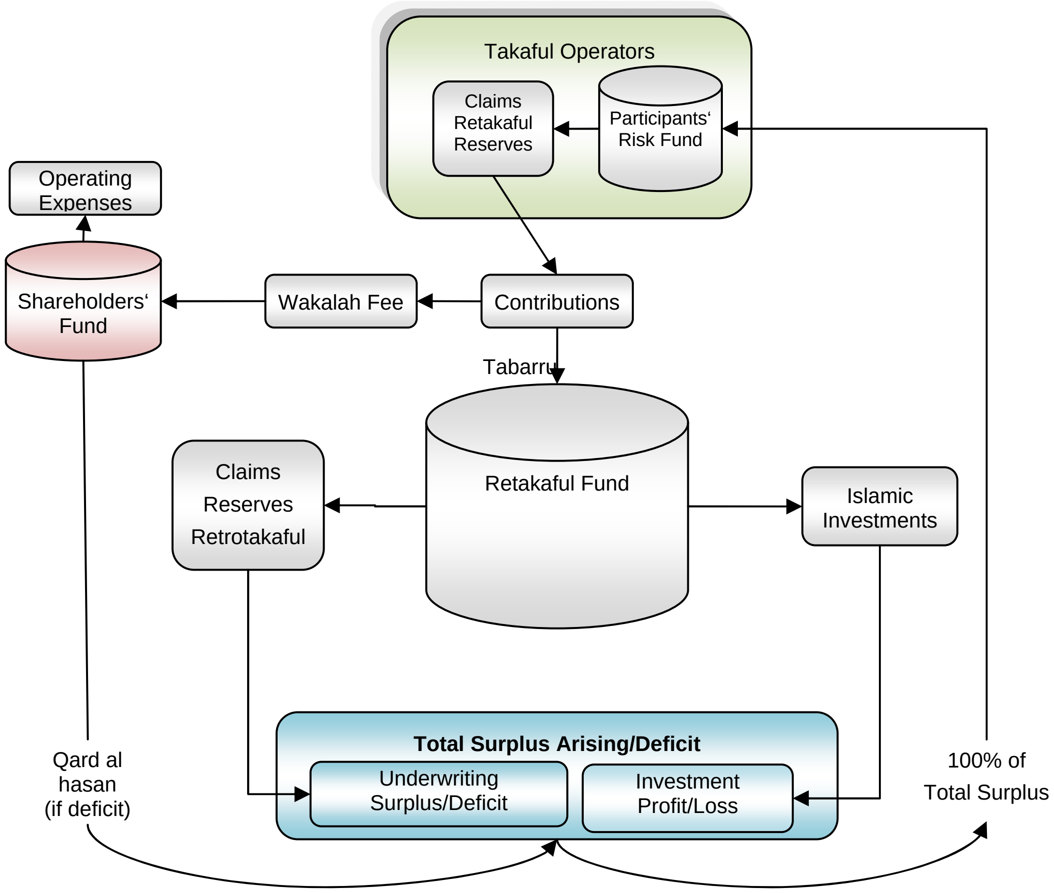


Figure 8: Retakaful – Pure Wakalah Model

Retrotakaful refers to retrocession of retakaful business to other retakaful companies. It is not permissible to retrocede to conventional reinsurers, in which case it would have to be referred to as simply retrocession. The business motive for retrotakaful is usually to increase the capacity of the ceding retakaful, cede out more risky business or help jump-start newly formed operators initially lacking the critical mass.

Conventional retrocession is very common nowadays due to the high capacity available in the global insurance market. It is a different story for retakaful though, due to the limited number of players and capacity available.

1.3.1.9 Takaful Model Overview

We have seen that a variety of operational models can be found worldwide, all of which can be broadly classified as follows:

	Mudharabah on Tabarru	Mudharabah on Investment	Wakalah
Pure Wakalah			☐
Wakalah with Incentive Compensation	(☐)	(☐)	☐
Pure Mudharabah		☐	
Mudharabah	☐	☐	
Wakalah Mudharabah		☐	☐
Wakalah Waqf		☐	☐

1.3.1.10 Numerical Examples

The models implemented and parameters applied vary widely by company and even product, but some figures are provided in the table below for the reader so as to get a sense of the parameters actually used by selected takaful operators (the profit-sharing is from the operator's perspective, i.e. his share):

	Wakalah Fee on Contribution	Wakalah Fee/Urjah on Investments Value	Performance Fee on Investment	Performance Fee on Underwriting	Mudharabah on Underwriting	Mudharabah on Investments
Pure protection product	40%	-	-	-		
All Products	30%	-	50%	50%		
All Products					70%	70%
All Products	15%					15%
Single Contribution ILP	5% on SC 10% on tabarru drippings	1.00% - 1.25% (varies by fund)	-	-		
Single Contribution ILP	20% on SC 5% on top-up	1.5%	0% to 15% of investment profit (varies on fund performance)	30%		
Mortgage	25%					20%
Fixed Contribution ILP	5%	1.3%				30%

1.3.1.11 Ownership of the Takaful Fund

The takaful fund is jointly owned by all participants as opposed to the shareholders in a conventional insurance company. The takaful operator only has the mandate given by the owners to administer the fund as per contract agreement. For instance the Labuan regulation states that "*the [takaful fund] does not belong to the IFI [Islamic Financial Institution] but rather belongs to the participants collectively.*[1]"

This gives rise to two concerns:

- Firstly, the group of participants is not a separate legal entity. It also means that there is no explicit guarantee that takaful benefits will be paid in full under whatever circumstances if the takaful fund runs into a deficit.
- Secondly, the agency character can give rise to a classical principal-agent-problem, if interests are not properly aligned. All of the models above comprise an incentive element to avoid cases of moral hazard or misconduct by the operator (and participants). However, one has to acknowledge that legal redress is limited to negligence of the operator. Corporate governance is thus key in takaful business to ensure all stakeholders are treated fairly. It is important due to high reliance by the participants on the takaful operator in ensuring that the takaful business is being properly managed.

1.3.1.12 Sharing of Underwriting Surplus

Closely related to the ownership question is the sharing of surplus arising from the takaful fund. It has already been mentioned that this is a highly controversial topic within in the takaful community and the trend is towards prohibiting the sharing from this fund. This is also laid out in the following standard:

> ***AAOIFI Financial Accounting Standard No. 13 Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies:***
>
> - *Entitlement to the insurance surplus belongs only to the policyholders. Shareholders do not share in this surplus, because it belongs to policyholders collectively as defined by the insurance agreement. Several fatwas and Shariah rulings have been issued confirming that policyholders have the exclusive right to the insurance surplus.*
> - *The insurance company may invest the insurance surplus for the account of the policyholders if there is an express provision to this effect in the insurance policy. The consideration payable to the party undertaking such investment (i.e. percentage of investment profit in the case of mudharabah or amount of commission in the case of agency) should be specified in the insurance policy.*
> - *The party undertaking the investment is entitled only to the consideration specified for this purpose, and should not appropriate any amount from the insurance surplus which is a residual from the premium contributions.*

However, the AAOIFI standards are not accepted by all operators as we can see from the following resolution (ref no. 09/07/07) by the Shariah Advisory Council of Bank Negara Malaysia on the

[1] Refer to article 11 of *The Guidelines of Takaful and International Retakaful Business in IOFC.*

distribution of underwriting surplus, which has been market practise by some operators in Malaysia since inception of its first takaful operator in 1979:

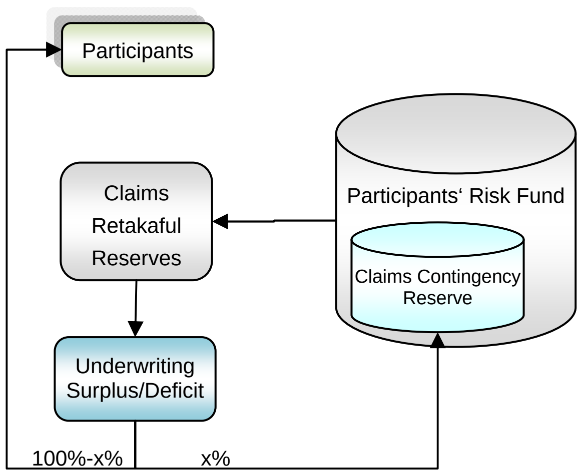
> ***The Shariah Advisory Council of Bank Negara Malaysia (the Council) has made the resolution that the distribution of surplus from tabarru' fund in takaful scheme is permissible from Shariah perspective.***
>
> *The Council's resolution in allowing the distribution of surplus from tabarru' fund (for both family and general takaful plans) to the participants/certificate holders and takaful operator is based on the premise that takaful contract is generally established on the Shariah principles of tabarru' (donation) and ta'awun (mutual cooperation), apart from the agreement among the contracting parties. In the formulation of takaful product, the principle of tabarru' has been the main underlying Shariah principle, although the application of other principles such as wakalah and mudharabah also complement the takaful operational structure. The Council's resolution to allow such distribution is also based on the permissibility of performance fee for the takaful company. It is noted that in general, such method of distribution is practiced by several takaful companies in the Middle East.*

1.3.1.13 Claims Contingency Reserve

The claims contingency reserve (CSR) acts as a buffer against an adverse claims experience and is built up by past underwriting surplus from the takaful fund (under the waqf model it does also stem from the initial capital injection by the shareholders). Any deficit within the fund will be charged to the contingency reserve before a qard al hasan is provided.

If the underwriting result of the takaful fund is positive, the reserve will be used to repay any outstanding qard al hasan first. If there is any positive surplus after repayment of the qard al hasan, a percentage of the surplus will be allocated to the contingency reserve.

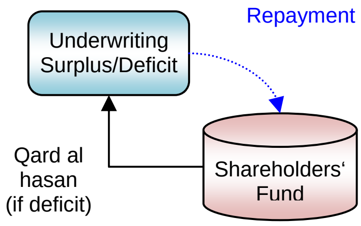
There is no agreed market standard on how much can be allocated to the CSR, but it is obvious that there has to be a cap on the reserve, determined by actuarial methods and varying by the risk profile of the takaful fund (actual percentages by takaful operators vary and may be in the range of 15% to 30% or even 100% if all underwriting surplus is retained within the fund).



As the underwriting surplus is directly linked to the reserves (both statutory and CSR) it is obvious that a conflict of interest between participants and operator exists. If the operator does not share in the underwriting surplus arising he might prefer to set more conservative reserves and vice versa. However, regulators ensure that an appointed actuary controls the calculation and setting of reserves so as to ensure a fair treatment of the participants.

1.3.1.14 Qard al Hasan

The takaful operator is commonly expected to provide an interest free loan in case of a deficit in the takaful fund, but it has to be noted that this is not explicitly mandated by the Shariah. The loan will be repaid out of future surplus arising, though both timing and amount are uncertain (this arrangement is similar to a loss carry forward arrangement in the profit commission under conventional reinsurance).



The provision of the qard is either benevolent, part of the agreement between participants and operator or mandated by the regulator. The draft of the Pakistani *Takaful Rules 2005* for instance states under Article 15:

> *"In case of a deficit in the PTF (Takaful Fund), the Takaful operator shall undertake to give Qard-e-Hasna to the PTF to make good of the deficit. The Qard-e-Hasna may be recovered from future surpluses without any excess on the actual amount given to the PTF.* "

The Labuan regulator provides more leeway in its *Guidelines of Takaful and International Retakaful Business in IOFC*, stating under Article 20.II that the

> *funding of an underwriting deficit can be done either via a qard al hasan or by way of any other form of payments in line with the Shariah and this has to be clearly spelt out in a binding contract agreement.*

The mode of repayment of a qard is usually not stipulated but subject to the consent of the Shariah board. It might for instance advise to not fully recuperate the qard in one go (provided the surplus is higher than the qard), but rather in instalments over time, e.g. to ensure intergenerational fairness amongst the participants.

Some regulations, such as Bahrain (CBB, Section CA-8.4.4) allow that an underwriting deficit might be financed from another takaful fund (e.g. a deficit in the group family fund might be funded via a qard from the individual family takaful fund), provided it will not financially threaten the funding fund and adversely affect policyholders' reasonable expectations.

Under an adverse scenario the shareholders' might even have to write off their loan if there is an continuing deficit in the fund.

How the free loan is treated in the financial statements is described under section 1.3.1.16.

1.3.1.14.1 Motivation of a Qard al Hasan

The reason why the operator is expected to provide a qard al hasan might originate out of two reasons. Firstly, it is hardly practicable to ask each and every individual participant to inject more capital into a deficit fund. Secondly, the operator as manager of the pool shares the risk of a deficiency as part of his mandate.

1.3.1.14.2 Technical Notes

- One aspect that has to be kept in mind is how to maintain fairness between different generations of policyholders, in particular future generations: participants that newly joined a pool with a positive qard al hasan will be negatively affected as they might receive a smaller share of the surplus arising due to the (partial) repayment of the qard.

- There is obviously a related risk that participants decide to leave the pool once the fund is in a deficit if they cannot expect to receive any surplus in the near- or midterm.
- It might be difficult to convince potential participants to join a pool that is in a deficit.
- It is important to point out that it is not allowed to include a qard al hasan provision in the takaful pricing as it defeats the intention of a benevolent or interest free loan.

1.3.1.15 Shariah Supervisory Board

Every takaful operator has a Shariah Advisory/Supervisory Board (in addition to any Board of Directors requirements) to ensure Shariah compliancy of the operation at all times. It usually consists of at least three members - all of which must be Shariah scholars or well versed in Shariah - and reports to the Board of Directors. Many countries, such as Malaysia, Bahrain or Sudan require members to be approved by the National Shariah Council.

It has to be stressed that the board members do not have executive power but a pure advisory role so as not to mix the two different functions.

In the early years of takaful there has been little governance of the Shariah Advisory Board, but regulators are increasingly establishing guidelines to allow for an effective Shariah framework. A good example is the *Guidelines on the Governance of Shariah Committee For the Islamic Financial Institutions* (BNM GPS 1, Dec 2004)[2]:

- *"These Guidelines aim at achieving the following:*
- *(a) to set out the rules, regulations and procedures in the establishment of a Shariah Committee;*
- *(b) to define the role, scope of duties and responsibilities of a Shariah Committee; and*
- *(c) to define relationship and working arrangement between a Shariah Committee and the SAC of Bank Negara Malaysia."*

The core duties and responsibilities of the Shariah board members are spelt out as follows in the guidelines:

- To advise the operator or related parties on all Shariah matters in its business.
- To endorse and validate relevant documentation, like the product manual, policy terms and conditions, marketing material, sales illustrations.

A common requirement for operators is to submit new Islamic products for regulatory approval, accompanied by the Shariah concept applied, including the relevant fiqh literature, supporting evidence, precedence and reasoning[3].

Vice versa, the takaful operator is obliged to support the Shariah board accordingly:

[2] http://iimm.bnm.gov.my/index.php?ch=20&pg=63

[3] See *Format for Submission of Islamic Financial Products to be endorsed by the SAC of LOFSA* for an example (www.LOFSA.org.my).

- To refer all Shariah issues to the Shariah board, provide access to relevant documents and adopt their advice.
- Ensure that all relevant documentation is validated by the board.
- To provide sufficient resources (manpower, budget, training) for the board to be able to fulfil their duties.
- To remunerate the members accordingly.

1.3.1.16 Reflection of Takaful in the Annual Returns

The financial statement for takaful operators are reflecting segregated shareholders' and participants' funds (with separate family and general takaful funds). The accounting practices vary widely and there is yet no common standard applied in the main takaful markets, despite the existing AAOIFI standards.

A simplified model of the Balance Sheet would look as follows: On the company level three separate funds need to be established for the two classes for business and the shareholders' fund.

Company Balance Sheet	Family Fund	General Fund	Shareholders' Fund	Total
I. Liabilities and Shareholders' Equity				
A. Takaful Fund and Reserves				
▪ **Participants' Fund**				
▪ **Investment-linked Fund**				
▪ **Unearned Contributions Reserve**				
▪ **Surplus attributable to Participants**				
▪ **Other Reserves**				
B. Other Liabilities				
...				
▪ **Interest Free Loan (Qard al Hasan)**				
...				
C. Amount Due to Income Statement / Takaful Fund				
...				
F. Shareholders' Equity				
II. Assets				

A separate statement for each fund is required, for instance for the family fund as shown below, assuming that only ordinary (individual and group) and investment linked business is written. Here it is necessary to show separate figures for the various sub-funds.

Family Fund Balance Sheet	**Ordinary Family**			
I. Liabilities	*Participant's Investment Fund*	*Participants' Risk Fund (Takaful Fund)*	*Group Takaful Fund*	*Investment Linked*
A. Takaful Fund and Reserves				
▪ **Participants' Fund**				
▪ **Investment-linked Fund**				
B. Other Liabilities				
▪ **Amount due to retakaful/ceding companies**				
▪ **Interest Free Loan (Qard al Hasan)**				
...				
C. Amount Due to Income Statement/Takaful Fund *				
...				
II. Assets				

* Item C comprises the following items:

- Surplus retained b/f from last year
- Current year revenue surplus/deficit as per income statement
- Surplus payment to shareholders' fund

The income statement, reflecting the "from top to bottom line" view, can be sketched as follows:

Income Statement	**Amount**
A. Operating Revenue	
▪ Gross contribution income from takaful funds	
▪ Gross investment income from takaful and shareholders' funds	
B. Shareholders' Fund	
▪ Wakalah Fee	
▪ **Investment Income**	
▪ **Management Expenses**	
o **Shareholders' Fund**	
o **Takaful Funds**	
...	
C. Surplus/Deficit Transferred from	
▪ **General Takaful Fund**	
▪ **Family Takaful Fund**	
D. Finance Costs	
E. Profit Before Tax and Zakat (B+C-D)	
F. Taxation	
G. Zakat	
H. Extraordinary Items	
I. Net Profit for the Year (E-F-G+H)	

- Wakalah fee and mudharabah shares should be stated in a separate takaful fund statement, where underwriting and investment operations' revenues and expenses of the takaful fund are declared.
- *Management Expenses* must include Shariah Advisory Board member's remuneration and related expenses.
- The *qard al hasan* is technically an interest free loan with no fixed repayment terms.

1.3.1.17 Takaful Standardization

We have seen the variety of models and view on various takaful issues and one might ask whether at one point in time a common takaful model and practices would be applied.

There is indeed a trend to standardize the Islamic Finance industry, driven by rulings of the Islamic Fiqh Academy of the Organization of Islamic Conference (OIC) and concerted efforts by various interest groups such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB) and Global Takaful Group (GTG) which aim to develop standards and guidelines for Islamic financial institutions and regulators.

The global trend for the operational model is towards a wakalah based model without any sharing of the underwriting profits, which is underlined by the approval of this model by the AAOIFI. But a global standard is not yet in sight, mainly due to varying opinions and interpretations of Shariah scholars. A second impediment towards global standardization are the practical difficulties and ground realities which cannot be changed overnight.

1.4 *Takaful Markets*

Having analyzed the operation of a takaful setup we will now look at various takaful markets and how they have implemented takaful. We will start on a global level and subsequently zoom in on selected takaful markets.

1.4.1 Worldwide Takaful Market

Takaful started in 1979 in the MENA region with the launching of two companies in the UAE and Sudan, but it took some time for the movement to take shape. Later in 1984, Malaysia played a pioneering role in setting the first legal framework specific to takaful (Takaful Act 1984). This was instrumental in the successful launching of the takaful movement in Malaysia and in other countries of Southeast Asia. Other markets such as the Sudan and Iran have Islamic regulatory environments and may be naturally viewed as "takaful" markets. In the Gulf countries specific takaful legislations are coming through in Bahrain and in Saudi Arabia. South Africa has introduced takaful regulations in 2006.

Despite the dramatic growth of Islamic financial instruments, takaful was for long regarded as the "poor cousin" of Islamic banking. It remained an insignificant insurance segment until early 2000 when sales figures started to increase due to efforts by some governments like Malaysia to promote takaful growth. However, the development status of the insurance markets varies significantly from country to country. It strongly depends on the affluence of the population. Another key factor for takaful growth is the emphasis the respective insurance supervisory body places on Islamic principles.

Estimates of the global takaful premium vary widely due to the lack of consistent and credible data. It is estimated to have crossed the US$3 billion mark in 2007.

Total takaful premium still pales in comparison to the conventional side as can be seen from the table below. But it is its potential and exponential growth in the recent past that makes takaful a new insurance market not to be missed by both local and international players.

The following table shows key indicators relevant for an analysis of the growth potential of selected takaful markets (Source: Takaful Re, Asian Insurance Review 3/2007):

(in million US$)	**Share Muslims**	**Population (in million)**	**Muslim Population (in million)**	**Life Premium 2006**	**Life Insurance Penetration 2006**	**Estimated Takaful premium 2005**
Saudi Arabia	100%	25.2	25.2	19	0.0	755.6
Malaysia	60%	25.8	14.5	4,881	3.2	516 (2006)
Kuwait	85%	2.8	2.0	113	0.1	82.9
UAE	76%	4.7	1.9	418	0.3	41.5
Qatar	95%	0.8	0.8	26	0.0	33.6
Indonesia	88%	225.5	207.0	2,822	0.8	74.2
Thailand	5%	64.8	3.3	3,887	1.9	30.0
Brunei	65%	n/a	0.2	n/a	n/a	27.0
Bahrain	93%	n/a	0.7	n/a	n/a	15.0
Jordan	95%	5.8	5.5	36	0.3	14.5
Egypt	85%	75.4	70.5	356	0.3	3.0
Pakistan	97%	161.2	159.8	375	0.3	0.1
Singapore	16%	4.4	0.7	7,080	5.4	0.1
India	13%	1119.5	151.4	37,220	4.1	n/a
China	2%	1323.6	19.6	45,092	1.7	n/a
UK	3%	60.6	1.6	311,691	13.1	n/a
Germany	4%	82.7	3.0	94,911	3.1	n/a
France	7%	60.5	4.2	177,902	7.9	n/a
WORLD	**23%**	**6,448**	**1,500**	**3,723,412**	**5.5**	**2,800 – 3,000**

Figure 9: Takaful Potential Overview

We can make two important observations: Firstly, low life insurance penetration rates in the Middle East is one promising indicator for a flourishing takaful industry in the long run. Secondly, there are quite large Muslim minorities in non-Muslim countries adding to the positive takaful outlook.

1.4.2 Worldwide Takaful Outlook

The potential for takaful is a highly discussed topic with widely varying estimates, depending on the various calculation methods and assumptions. To provide a somehow balanced view three often-cited sources are listed below:

Md Azmi Abu Bakar, CEO, Takaful Malaysia estimates "*a takaful volume of **$10.9 billion** by 2015 with 38% written in the Middle East and 35% in Asia*". This prospect is based on the sheer size of over 1.5 billion Muslim in the world, accounting for only a fraction of total insurance volume. I.e. notwithstanding the global economic growth, insurance penetration among Muslim countries as %age of the GDP is still relatively low. He further expects that "*family takaful will grow at a faster rate of 20% p.a. than general takaful with 8% p.a.*". Hence family takaful would represent over 65% of total takaful premium in 2015, i.e. about $7 billion.

According to the International Herald Tribune (10 Oct 2006, "Premiums soar for Islam-based insurance") *"worldwide premiums in the Islamic insurance industry will almost quadruple by 2015 because of demand from Muslims seeking to comply with their religious beliefs. The world's 250 Islamic insurers, or Takaful operators, will write **$7.4 billion** in premiums by 2015, up from $2 billion last year, Moody's said in a note to clients."*

According to AXCO (October 2006) *"South East Asia continues to be the main takaful market, accounting for an estimated 56% of the US$ 3bn global premium total with the Middle East accounting for 36% of this, but the whole market is expected to grow rapidly over the next decade. In the Gulf region the takaful market is expected to take off, with growth between 15% and 20% annually. Estimates vary but at the lower end of the scale some observers suggest that by 2015 global premium income could reach **$ 7.7billion** with the Gulf accounting for US$ 2bn of this figure."*

To sum up, estimates vary widely as takaful is still in the early stages. Whatever figure has been quoted has to be treated with caution. What can be said with some certainty though is that the under-developed takaful segment with expected growth rates of 15%-20% p.a. will outgrow the conventional insurance sector that did grow by just over 4% p.a. in the past. The table below shows the projected figures and the market share of takaful in comparison to conventional insurance of the under two growth scenarios:

(in billion US$)	**Insurance**	**Takaful**			
Growth Rates	**4%**	**15%**	**Market Share**	**20%**	**Market Share**
2006	3,723	2.6	0.7‰	2.6	0.7‰
2007	3,872	3.0	0.8‰	3.1	0.8‰
2008	4,027	3.4	0.9‰	3.7	0.9‰
2009	4,188	4.0	0.9‰	4.5	1.1‰
2010	**4,355**	**4.5**	**1.0 ‰**	**5.4**	**1.2 ‰**
2015	**5,299**	**9.1**	**1.7 ‰**	**13.4**	**2.5 ‰**

1.4.3 Selected Takaful Markets

It is worthwhile to look at the takaful environment in some markets in more detail so as understand the variety in models and maturity:

1.4.3.1 Sudan

Sudan is the takaful pioneer when it started Islamic insurance in 1972. A supervisory law was issued in 1992 requiring Shariah compliancy for all companies; currently the Insurance Act 2003 applies. Hence there is no conventional insurance in the Sudan and all takaful companies operate on cooperative principles using a mixed wakalah mudharabah model. Technical and management expenses are met from the takaful fund and there is no legal obligation for a qard al hasan by the shareholders.

Shariah compliance is supervised by the company's own Shariah Supervisory Board and the national High Shariah Supervisory Board (HSSB). The HSSB is part of the Insurance Supervisory Authority of Sudan (ISA) and has final authority in Islamic insurance matters.

1.4.3.2 Malaysia

The strategy adopted by Malaysia has been to develop a comprehensive Islamic financial system that operates in parallel with the conventional system. It has been a gradual and pragmatic evolution over time. Malaysia was the first country to implement a regulation specific to takaful (Takaful Act 1984) and it required that a takaful operator has to operate as a dedicated subsidiary. The regulator, Bank Negara Malaysia (BNM), has a fairly strict approach towards the legal set-up of a takaful as it does not allow window operations. This is unlike for the Islamic Banking sector, where Islamic windows are still allowed.

The act has been amended in 2007 and is now extending the modus operandi to branches of international companies as well. Companies need separate licenses for family and general takaful business but composite companies are allowed. The regulator ensures that no cross-subsidies between the two lines of business take place.

BNM has its own National Shariah Advisory Council (SAC) to ensure a common view on Shariah issues which does facilitate standardization of Shariah issues.

There is no restriction on the takaful models to use (i.e. wakalah, mudarabah or combination) as long as it approved by the SAC. All but one operator are applying a form of the wakalah model, some with performance incentive elements.

1.4.3.3 Labuan

Labuan is an island off the coast of East Malaysia, administered by the Federal Government of Malaysia and Malaysia's offshore financial centre (i.e. for non-domestic business transacted in a foreign currency) and regulated by the Labuan Offshore Financial Services Authority (LOFSA).

Takaful is embedded within the existing Offshore Insurance Act 1990 by setting out additional guidelines, such as *The Guidelines of Takaful and International Retakaful Business in IOFC*.

Companies are allowed to set up takaful windows and operate under the wakalah and/or mudharabah or any other model, subject to the endorsement of the Shariah Advisory Council of LOFSA (Article 10, 11, 14).

The funding of an underwriting deficit can be done either via a qard al hasan or any other form in line with the Shariah and this has to be clearly spelt out in the contract agreement (Article 20.II).

1.4.3.4 Pakistan

The Securities Exchange Commission of Pakistan (SECP) has drafted Takaful Rules in 2005 that stipulate the set-up of dedicated takaful companies, disallowing any kind of takaful window until 2010 to give fully-fledged takaful operators a head-start. Composite companies are not allowed either in line with the regulation for conventional insurance companies; proposed capital requirements are the same for both takaful and conventional companies. The takaful fund has to operate on waqf wakalah or mudharabah model but does not allow a sharing of the underwriting surplus.

The Takaful Rules have not yet become effective, primarily because of a disagreement between regulator, conventional and takaful companies on whether takaful windows should be allowed or not and all parties have strong arguments pro/con on their side.

1.4.3.5 Bahrain

The Central Bank of Bahrain (CBB) assumed regulatory and supervisory responsibilities for the supervision of insurance sector and capital market in 2006. Takaful has been handled within the sphere of the current insurance regulation, the Insurance Rulebook, issued in 2005. The leading idea was to take into consideration the unique characteristics of takaful companies and align the regulation of Islamic insurance as far as is reasonably possible with its proposals for conventional insurance. At the same time it wanted to be in line with international standards, such as those set by the AAOIFI.

The CBB does not allow takaful windows and composite companies, the model to be applied is the wakalah on the tabarru fund and mudharabah on the investments.

The CBB requires separate margins for the takaful and shareholders' fund. The need for a separate solvency margin for the shareholders' fund lies with the operators obligation to provide a interest free loan in case of a deficit in the takaful fund. It is important to note that for the SHF the solvency requirements are simplified (minimum fund) and that there is no admissibility restriction on investment.

1.4.3.6 Singapore

The Monetary Authority of Singapore (MAS) has opted to accommodate Islamic insurance within the existing supervisory framework for insurance companies, as many of the supervisory processes and prudential measures are common to both conventional and Islamic insurance activities. It will not be making any fundamental changes to their supervisory framework, but will fine-tune the rules along the way to facilitate its developments.

MAS allows insurance companies to operate takaful windows and no additional capital is required for windows as takaful can basically be seen as a new class of business.

1.4.3.7 Qatar

The Qatar Financial Centre Regulatory Authority (QFCRA) has amended the Insurance Rulebook to set out *Additional Requirements for Takaful Entities* under Chapter 6 . It allows the operation of takaful windows, but requires separate books of accounts to be kept. All relevant AAOIFI Standards have to be followed, such as the standard *No. 13 'Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies'* (refer to *1.3.1.12 Sharing of Underwriting* Surplus), which disallows the sharing of underwriting surplus. As common in all other markets, a Shariah Advisory Board has to be established and an appointed/approved actuary has to be engaged for surplus/deficit valuation.

1.4.3.8 United Kingdom

The Financial Services Authority (FSA) has adopted a *'no obstacles, but no special favours'* approach in handling takaful business and has only recently approved the first license to a wholly Islamic General Takaful Provider. Like other regulators in pre-dominantly non-Muslim countries, the FSA will manage takaful operators within their current regulatory framework and develop it over time.

The FSA has outlined three potential difficulties when it comes to takaful[4]: Firstly, that takaful products may appear similar look to conventional products, but have a different underlying structure. Secondly, the role and responsibility of the Shariah Supervisory Board has to be purely advisory and not executive. Thirdly, the marketing and promotion of takaful products must be fair, transparent and not misleading, in the spirit of the "treating customers fairly" principle.

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[4] *Islamic Finance in the UK* (Nov 2007), FSA

1.4.3.9 Saudi Arabia

The supervisory authority Saudi Arabian Monetary Agency (SAMA) requires that insurers must operate on a cooperative basis. There is no detailed framework as to how cooperative insurance is to be conducted. Rather, within the regulatory framework the only real restrictions on an insurer's operations are the requirement to maintain separate profit and loss accounts for participants and for shareholders and that there must be a distribution of part of the net surplus from the insurance operations among the policyholders. Therefore, it is open to insurers to write business essentially on a commercial basis, subject to the redistribution element on a semi-cooperative basis.

1.4.3.10 Regulatory Overview

One can summarize from the above that regulators in traditionally conventional insurance markets are applying a "level playing field" approach by incorporating takaful specific guidelines/sections within the existing regulatory framework.

	Regulator	Takaful Windows allowed?	Does regulation allow sharing in underwriting surplus?	Separate Takaful Regulation?	Note
Malaysia	Bank Negara Malaysia (www.bnm.gov.my)	✗	✔	✔	Takaful Act 1984
Pakistan	Securities and Exchange Commission (www.secp.gov.pk)	(✗) under discussion	✗	✔	Draft Takaful Rules 2005
Labuan	Labuan Offshore Financial Services Authority (www.lofsa.gov.my)	✔	✔	✗	Guidelines of Takaful and International Retakaful Business in IOFC
Bahrain	Central Bank of Bahrain (www.cbb.gov.bh)	✔	✗	✔	Insurance Rulebook Volume 3-Insurance
Qatar	The Qatar Financial Center Regulatory Authority (www.qfcra.com)	✔	✗	✗	Insurance Rulebook, Chapter 6: Additional requirements for Takaful Entities
Saudi Arabia	Saudi Arabian Monetary Agency (www.sama.gov.sa)	✗	✔	✔	Law on Supervision of Cooperative Insurance Companies and its Implementing Regulation
Singapore	Monetary Authority of Singapore (www.mas.gov.sg)	✔	✔	✗	Insurance Act
Sudan	Insurance Supervisory Authority of Sudan (www.cbos.gov.sd)	✗	✔	✔	Insurance Act 2003
UK	Financial Services Authority (www.fsa.gov.uk)	✔	(✔)	✗	Financial Services and Markets Act 2000

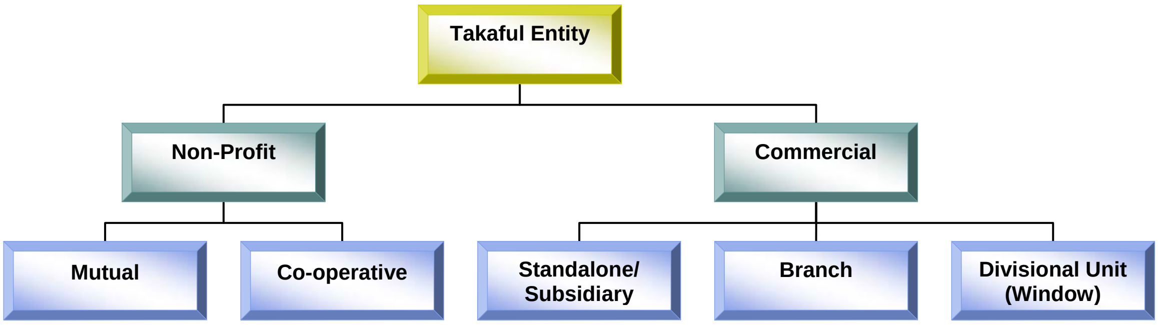
Section 2

2 Risk and Challenges

Having learnt about the principles and practises of takaful the focus is now on the implementation. Several factors have to be considered when a company wants to enter the takaful market and in the following the most important issues are looked at in more detail, accompanied by some practical comments.

2.1 Legal Structure

There are principally four ways to set up a takaful operation and the pros and cons will be discussed in the following. It has to be noted that, depending on the prevalent regulation, the legal set-up may be prescribed.



2.1.1 Commercial Company

- Separate standalone takaful company or subsidiary of mother company
- Branch of mother company
- Takaful Division under the existing conventional insurance arm (also known as "takaful window")

Setting up a new company or a branch requires a significant capital investment if compared to a takaful window and this does often pose an entry barrier. A takaful window is a more cost effective, less capital-intensive and pragmatic approach but there are concerns that a window does not allow for proper segregation of takaful business from conventional business and not fully comply with Shariah principles at all times.

Credibility and reputation are a major issue here as well, but we have also seen Islamic banking and finance prosper through the utilization of Islamic windows and many of these operators are now looking to develop dedicated Islamic operations or have already done so. In particular the windows of international banks or insurance companies have contributed significantly to the success of Islamic finance due to their global experience in production and distribution of products and better financial capabilities than most the local Islamic operators. It also holds true that greater competition, if managed properly by the regulator, does benefit both the market and consumer.

The difference between operating as a branch of an international company and setting up of a subsidiary is primarily a lower capital requirement as the branch has the full financial backing of its mother company. This does further imply that a takaful branch inherits the financial rating, unlike for a subsidiary where substantial capital would be needed to gain for instance a first-grade rating.

2.1.2 Mutual/Co-operative

In a mutual company, policyholders own the company and control the management. It is hardly feasible though in practice for the policyholders to effectively control the management. Policyholders are numerous and widely scattered geographically; they do not perceive themselves as being responsible also in view of their small individual stake in the mutual. Furthermore they usually do not have the knowledge to understand and effectively control the operation. In practise though, some mutuals/co-ops are run by professionals and compensated accordingly, either by a share in the surplus or a fee.

A mutual/co-operative has much in common with the principles of takaful, such as member-or ownership, mutual help and solidarity and is often regard as a perfect organisational fit for a takaful. Mutual companies are sometimes facing financial constraints though as they cannot raise additional capital (their only source of equity capital is retained earnings) to expand and compete against traditional insurers, which often lead to demutualization in the past.

2.1.3 Source of Capital

An often raised question is whether the capital required for setting up takaful operation can originate from non-Shariah compliant sources, e.g. from interest based income of conventional insurance companies who want to go into takaful. There are different schools of thought but it is widely seen as acceptable, even if some of the sources are haram. This aside, it would be very difficult to start up a takaful operation if it would be prohibited. The same applies in respect of additional capital injections. What is crucial here is that the use of the capital injection is fully in line with the Shariah.

2.2 *Regulatory Considerations*

The regulatory approach towards takaful differs by jurisdiction as summarized in *1.4.3.10 Regulatory Overview*. For example, some have a separate regulatory framework that exists in parallel to their conventional framework, while others have regulated both Islamic and conventional insurance within a common regulatory framework.

The regulator does usually not establish rules as to what constitutes a takaful product; this is a matter for each firm’s Shariah Advisory Board. But all transactions have to be in line with the civil/criminal law in secular countries to ensure legal and contractual enforceability.

However, the regulator has an obligation to ensure that consumers of takaful products are afforded the same level of protection as that afforded to the purchasers of conventional insurance products. In addition, it has an obligation to ensure that the operations of takaful firms do not represent a threat to the stability of the financial services industry or wider economy.

‘Level playing field’ or ‘no obstacles, but no special favours’ are phrases used when it comes to the treatment of takaful business within a conventional insurance environment, i.e. the regulatory environment is not favouring one form over the other.

Main areas typically looked at from the regulator’s perspective are:

- Establishment of a Shariah Advisory Board to direct, review and supervise the activities in order to ensure that they are compliant with Islamic Shariah rules and principles.
- Business conduct, importance of transparency and disclosure particularly relating to wakalah fee, mudharabah share of profits (if applicable), surplus allocation and distribution and future obligations participants may incur.
- Strict segregation of shareholders’ and takaful fund, as well as separate funds for general and family takaful.

- Capital adequacy and solvency requirements are usually in line with conventional insurance requirements, although Bahrain has given it some more thoughts (as described under 1.4.3.5), taking into account the qard al hasan risk for the operators.
- The contractual requirement for a qard al-hasan as a takaful operator could otherwise refuse to provide such a loan. This is of particular importance in case of a winding-up.

The challenge for the takaful operators is to operate under such evolving regulations, where guidelines might be vague and operators are sometimes entering legally unchartered waters. Regulators' 'level playing field' approach does sometimes not fully consider specifics of a takaful operation and applying conventional standards might not be that straightforward or even not appropriate. Important issues like whether or not a qard al hasan is obligatory, whether there is a legal redress to shareholders' capital in case of a winding up, how risk based capital is applied, how surplus is determined and shared or how Shariah compliancy is regulated are some of the numerous issues that have not been yet fully dealt with by regulators.

2.3 *Limited Data*

The backbone of every business plan is the assessment of the market potential. As outlined in the introduction, the potential is enormous considering the sheer size of the Muslim population, which is mostly un(der)insured and its favourable demographic profile with a rather young population. The dramatic growth of the Islamic financial market and creation of 'bancatakaful' distribution channel does further fuel the demand. But caution has to be applied in any projections as takaful is still in its infancy in most markets and there is little credible data available.

2.4 *Market Approach*

"Different strokes for different folks" is the maxim when it comes to developing a market strategy as the markets vary widely in terms of awareness level and needs.

It also has to be recognized that there is a large Muslim minority in non-Muslim countries such as India, China, France, Germany or the UK. Vice versa, Malaysia is an example of a Muslim country with a sizeable non-Muslim minority. We can basically distinguish between three target markets:

- In more mature takaful markets like Malaysia where there is also direct competition with conventional insurance companies, the takaful operator has to apply a two-sided strategy: Firstly, capturing market share from conventional insurers and secondly, to exploit the untapped market of Muslims that has reservations towards conventional insurance.
- Takaful markets on the rise, especially in the Middle East where the insurance penetration is extremely low, require raising awareness about takaful and educating the population. Increasing the insurance penetration rate is key for those markets.
- In developed insurance markets with significant Muslim minorities such as the UK or France the way forward is to reach out to Muslims both already insured and uninsured. Non-Muslims could also be targeted but without focusing on the religious aspects of takaful but rather on the ethical features.

2.5 *Marketing*

Generally speaking, raising awareness is key for the takaful industry. If there is a single challenge takaful operators could name as their biggest obstacle, it would be the lack of awareness of takaful both amongst the Muslims and the general public: When takaful first emerged the sole target group was the Muslim population and the simple but strong marketing message was that it is "insurance" for Muslims by Muslims, fully compliant with the Shariah. This has lead to the misperception that takaful is for Muslims only but in fact takaful is for Muslims and non-Muslims alike.

Admittedly, there is or has been some bias towards takaful due to cases of malpractices or because the service level of early takaful providers has not been up to customers' expectations. The Islamic operation of an international bank was using the tagline "*You want Islamic Banking – we'll provide it at world class level standards*" to differentiate themselves from competitors and seems to be an apparent message behind it.

We also cannot ignore that the reputation for conventional insurance is overall not a very good one and takaful could indeed become a more ethical alternative to insurance.

In multiracial countries it is important to also put an emphasis on the inherent features and benefits of takaful instead of the religious aspect. For instance, takaful can be marketed as the more ethical kind of insurance. The focus would be on the ethical and cooperative character, not to forget the surplus sharing and transparency features.

Takaful has its own lingo with terms like *takaful operator*, *contribution* or *participant* which might be confusing even to Muslims. Some operators have therefore marketed takaful as *Islamic Insurance*, *Ethical Insurance* or *Shariah Compliant Insurance* instead.

Depending on the target group marketing initiatives could have different messages:

- Mosque marketing, i.e. a form of affinity marketing in cooperation with mosques
- Marketing to faith-based associations
- Promoting products as ethical investments thereby targeting moderate and secular customers
- Highlighting the cooperative or mutual nature of insurance
- Primarily targeting from an ethnic angle

2.6 *Takaful Model*

The choice of the takaful operating model impacts regional acceptance, product design, marketing and pricing. As outlined above the two most common models are the wakalah and mudharabah model or a combination thereof:

- A mudharabah model might be more attractive as profit is shared with the policyholders but it might not be acceptable worldwide. This is because there is a strong opinion of scholars from the Middle East and Pakistan that underwriting profit cannot be shared with the operator as it stems from donations.
- The wakalah model is virtually accepted worldwide and has the positive effect of providing a fix and steady income stream. In its purest form it has limited upside potential as the only source of income is the wakalah fee. This could harm competitiveness as a high upfront wakalah fee might look unattractive to participants.
- There has been a trend towards a wakalah model on the underwriting and mudharabah on the investment part, i.e. a combined model accepted by the majority of Shariah scholars. Considering that investment income usually makes up the bulk of the profits, it would be a very sensible choice.

Whatever model chosen, the obligation to provide an interest free loan in case of a deficit in the pool requires careful risk management techniques. This is because it is uncertain when and if the loan will be repaid from future surplus arising. This is also where the 'insurance character' comes in, otherwise takaful could not be treated similar to insurance under international accounting standards.

2.7 *Products*

Generally speaking the kinds of products offered under takaful are comparable to that of conventional insurers as the insurance needs of both Muslims and non-Muslims in the same country are very similar. Similar but not the same as certain features cannot be provided under takaful, such as policy loans or guaranteed benefits. Due to the imminent uncertainty in the contract term whole of life cover would also not be acceptable under the Shariah.

A takaful operator will have to provide a similar product spectrum to conventional insurance not only to withstand the competition from insurers but also to attract non-Muslim customer in multi-racial countries. It is what he can offer on top or finding a niche what will make the difference in the long run.

2.7.1 Pricing

The paramount pricing principle is that fairness and equal treatment of all participants has to be ensured at all times. This, because the participants are the owners of the pool with equal rights and obligations. This does also imply that risk adequate contribution rates shall be charged to guarantee the long term sustainability of the pool. As the takaful model operates on a pooling basis two pricing methods could theoretically be considered: Either charging all participants the same takaful rates for the same product or quoting rates according to their individual risk profile, i.e. applying medical underwriting. Common practice is to charge individual rates, but unit rates may be applied e.g. for group insurance.

2.7.1.1 Pricing Methodology

The pricing is based on common actuarial principles as per conventional insurance and the takaful model applied has to be considered accordingly. The gross premium is thus made up of the net premium based on best estimates, expenses, tax and profit margin. It has to be noted that, contrary to a common misperception, the use of a profit margin (or 'mark up') and discount factor is usually allowed by scholars (although different schools of thought exist). A loading for a probable qard al-hasan is not allowed though.

2.7.1.2 Medical Selection

One issue particular to takaful is whether medical selection is within the Shariah spirit. Different Shariah opinions exist, but the common practice is that companies are using the same approach as in conventional insurance, i.e. age-specific rates and individual medical underwriting, thus charging extra contributions for substandard risks.

2.7.1.3 Pricing Basis

For the pricing basis the typical actuarial investigations have to be performed, in particular a proper mortality/morbidity and expense analysis:

- Mortality/morbidity: In multi-racial countries it is important to separately analyse the expected mortality of the target group Muslims and not to simply use the existing conventional mortality table. Muslims may have both a different socio-economic and genetic background with a different mortality experience. For instance, a lot of diabetes cases have been observed amongst the Muslim community within the UK. On the other hand it should be considered that overall there are positive factors, e.g. the ban on alcohol. This might cause less motor/road accidents amongst the younger Muslims that otherwise happen due to alcohol abuse.
- Lapse rates: It might be that lower lapse rates will be observed as there is currently a lack of competition in many takaful markets.

- Costs: A separate cost analysis is mandatory, considering the takaful model chosen and the additional resources and costs to ensure Shariah compliancy (expenses for Shariah Advisory Board). An additional minor factor to be considered is Zakat – an obligatory annual religious tax/levy and one of the five pillars of Islam, basically imposed on almost every Muslim except of the poor and needy. Non-Muslim owned takaful operators are not subject to Zakat. For companies it would be, broadly speaking, 2.5% of the net profits. It is meant for establishing social equity and leading the *ummah* (Muslim society) to prosperity.
- RBC requirements: Depending on the prevalent RBC regime, the takaful operator might incur a higher charge on his investment portfolio. This is because the investments have to be in Islamic investments, with potentially lower grades and higher RBC factors.

2.7.2 Underwriting

Underwriting for takaful is very similar to conventional underwriting but certain aspects require special attention, such as the occupational classification. For instance certain groups might be declined due to their non-Shariah conform nature, e.g. participants/industries related to alcohol or gambling.

2.7.3 Contract Wordings/Marketing Material

Conventional insurance policy conditions need a comprehensive revamp to incorporate the takaful specifics, it does not suffice to just change the terms (e.g. replacing premium with contribution or insured with participant); the same applies in full to marketing material. All documents also have to be vetted and approved by the Shariah Board.

With takaful being fairly new to most people transparency is very important to avoid misleading of customers. Hence the mechanics and risks of takaful have to be explained and the charges, fees and profit sharing parameters disclosed.

2.7.3.1 Late Payment Charge

The takaful operator is not allowed under the Shariah to charge for late payments for his own accounts. Any additional payment would have to be donated to a charity approved by the Shariah Advisory Board.

2.7.3.2 Exclusions

Exclusions vary by markets but standard clauses under life insurance are usually equally applied for family takaful, such as:

1. Suicide (usually within first year) for death benefit
2. Attempted suicide or self-inflicted injury whether you are sane or insane.
3. If you breached the law (civil, criminal).
4. If you provoked an assault.
5. If you were under the influence of drugs or alcohol.
6. If you were to suffer from AIDS or HIV.

An additional exclusion specific to takaful is the following which is basically an extension of exclusion number 3 above:

- Any other causes prohibited by Shariah.

The suicide clause is controversial as the cause of death should be immaterial under Shariah, however one can argue that it is an exclusion stated in the contract wording to which the participant has agreed to.

2.7.3.3 Guarantees

Takaful operates on a mutual assistance basis with the participants being the owners of the pool, i.e. no contractual guarantees, e.g. for benefits or contributions, are usually given by the operator. However, there might be a contractual obligation to provide a qard al hasan, even in case of winding up.

2.7.3.4 Ex-gratia Payments

Ex-gratia payments are common in conventional insurance, in particular non-life, usually given under out of business considerations. Such business decision are hardly justifiable under takaful being as it would directly affect the surplus of the takaful pool. However, ground realities typically prevail and ex-gratia payments are likely no less common under takaful in practise.

2.8 *Islamic Investments*

The success of the takaful industry is directly linked to the asset management capabilities of the Islamic finance industry. The fund of the shareholders and the fund of the policyholders have to be invested in a Shariah compliant manner and in a profitable manner. The more successful the asset management proposition would be, the stronger the takaful proposition would be.

However, there are several challenges faced by operators in respect of the investments, such as:

- The limited availability of Islamic investment options in general and long term and high quality instruments in particular leads to potentially lower investment returns, restricts product innovation, and increases the concentration and liquidity risk.
- It might further raise the capital requirements for takaful operators subject to risk based capital requirements and makes asset liability management more challenging vis-à-vis conventional insurance.
- Restrictions on the asset allocation of the takaful fund assets might be difficult to follow for a takaful operator due to the limited availability of proper Islamic investments.
- Suitable Islamic investments might be issued in a different currency (e.g. USD) exposing the operator to a potentially significant currency exchange risk.

Due to the special expertise and additional resources and systems required, takaful operators do often outsource this function to professional fund management companies.

2.9 *Shariah Compliancy*

Whatever the legal structure of a takaful operation might be, the most important aspect is full Shariah compliancy at all times:

- This requires a Shariah Advisory Board of usually three Shariah scholars. If a takaful operator has regional ambitions it is advisable that the members come from the target markets so as to underline the credibility. Scholars should ideally already have insurance/takaful experience to avoid possible miscommunication in discussions with business people. This is of particular importance as the board members have to certify the Shariah compliancy.
- Although the relationship between the Shariah Board and the management is usually one of deep trust and integrity it does not waive the requirement to set clear and written guidelines of the scope and responsibilities of the Board. This would for instance state how often the board would meet or provide for the right of an unannounced onsite inspection/audit.

- Compliancy covers all aspects of the operation - the takaful model, products, surplus sharing and fee structures, Islamic investments, contract wording, marketing material, etc (refer to 1.3.1.15).

2.10 *Reinsurance / Retakaful*

A lack of first grade retakaful capacity has always been cited as limiting takaful growth but with the entrance of global players, this bottleneck has been overcome. Prior to that most takaful operators still reinsured to conventional reinsurers, and this was considered acceptable as long as there was no practicable Shariah compliant alternative. This exception was based on the '*darurah*' or necessity principle.

Caution has to taken when deciding on the retakaful provider as it is sometimes the case that a provider is indeed using conventional reinsurance with Shariah contract wordings and/or retroceding to a conventional reinsurer, both of which might not be acceptable to the ceding company's Shariah Board.

The rule "necessities justify that which may be unlawful" is the most important principle that provides Muslims with guideline to bypass the impasse in practicing upon the principles of the Shariah.

2.11 *Systems/IT*

New or amended systems are required to cater for the specific takaful needs:

- Customer Relationship Management tools and distribution support tools might only require little changes, if at all.
- New tools might be considered such as a software tool capable of filtering client data by ethnic origin for direct marketing campaigns.
- Pricing does differ from conventional one and new or amended systems are necessary.
- The same applies for the policy administration system due to the need to keep separate shareholders' and participants' funds and additional data requirements.
- Unless the investment function is outsourced to a professional funds manager significant modifications are expected to the investment system.

2.12 *Competition with Conventional Insurers*

Takaful operators are often in a direct competition with conventional insurers as Shariah compliancy might not be the sole reason for consumers to buy protection. Consumers expect takaful operators to be on par with conventional insurers in respect of product offerings, service level, financial security and value-for-money. But takaful is a relatively young and small market and achieving a critical mass within a reasonably short period of time is difficult but crucial for a better spread of risks and particularly economies of scale. This is why takaful operators are also actively targeting the non-Muslims, with noteworthy success in Malaysia, or venturing overseas.

2.13 *Staffing*

There is a serious shortage of both Shariah advisors well versed in takaful as well as managers, actuaries, underwriters, accountants, sales agents and investment experts familiar with the Shariah principles. The staff and agents of takaful operators do mostly have conventional insurance background and require further training to fully immerse the takaful idea and specifics. Common trainings-grounds are international reinsurers/retakaful operators as well as organisations that provide seminars or courses on takaful or the Shariah.

2.14 *Evolving Regulations and Accounting Standards*

Takaful regulations, corporate governance and accounting standards are in the process of being harmonised and strengthened, ensuring the protection of consumers and the soundness and the stability of the takaful system. But there is still a long way to go and various interest groups have therefore been established, like the Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Global Takaful Group (GTG).

Section 3

3 Specific issues for India

This section deals with a few key issues which would be interest to market participants in India – including the regulator. These include the concern regarding what should be done to develop a robust Takaful market in India and a suggested roadmap to reach there, key aspects of Muslim demography in India, an estimate of potential (both business and distribution) in India and an estimate of mortality differentials in Muslim population as compared to the total population.

3.1 *Market Development and Regulations*

To draft a roadmap for development of a possible Takaful market in India, we look at the history of the Takaful market, development of regulations and reporting standards in Malaysia.

The Malaysian experience

The rise and development of Takaful products and the market in Malaysia might provide valuable insights into how such a market could be developed systematically. The development of Malaysian Takaful market provides a classical example of market participants and the regulator creating products and a robust environment to meet consumer needs.

The trigger for such products was essentially the growing religious revivalism, which manifested the need for Islamic products, further fuelled by the emergence of Islamic banking activities in the early 1980s.

The development of Takaful market in Malaysia occurred over three phases (Bank of Negara Malaysia, 2004 and Shahul Hameed bin Mohamed Ibrahim et al, 2007).

Phase I (1984-1992) – Introduction and regulation

The development of the takaful industry in Malaysia in the early 1980s was inspired by the prevailing needs of the Muslim public for a Shariah-compliant alternative to conventional insurance, as well as to complement the operation of the Islamic bank that was established in 1983. With the Islamic religious revival, the Malaysian National Fatwa Committee issued a decree which ruled that life insurance in its traditional form is a void contract due to the presence of the elements of Gharar (uncertainty), Riba' (interest) and Maisir (wagering). This triggered the introduction of the concept of takaful (Islamic insurance) in Malaysia in the later half of 1984 when the first takaful operator was established to fulfill the need of the general public to be protected based on Islamic principles. The legal basis for the establishment of takaful operators was the Takaful Act which came into effect in 1984, which focused on regulating takaful operators. Takaful operations are regulated and supervised by BNM since 1988 with the appointment of the BNM Governor as the Director-General of Takaful.

Phase II (1993 – 2000): Market development

This was the period when the consolidation of market, emergence of competition coupled with co-operation among takaful operators took place. In 1995, the ASEAN Takaful Group (ATG), a grouping of takaful operators in Brunei, Indonesia, Malaysia and Singapore was formed to enhance mutual co-operation and to facilitate the exchange of business among takaful operators in ASEAN. In 1997, ASEAN Retakaful International (L) Ltd. (ARIL) as an offshore retakaful company in Labuan, was formed. The establishment of ARIL was to facilitate retakaful activities among ATG members and to provide additional retakaful capacity.

Phase III (2001 -): Vision of BNM

Bank Negara Malaysia brought out a document titled "Financial Sector Master Plan" (FSMP) in the year 2000 which also envisioned a six point achievement target for the takaful market to be achieved in 2010. The document also contained recommendations on how to achieve these targets and were focused on three areas – Institutional capacity enhancement (enhancing efficiency of takaful operators, enhancing skill set of manpower employed by and the management team of these operators), Financial infrastructure development (measure to deepen the market and to stimulate Islamic financial engineering in product development and risk management), Regulatory framework development (to strengthen existing laws and guidelines and to move towards "code of ethics" approach from an approach requiring regulatory intervention).

It might be worthwhile noting the developments on the Islamic banking front and the parallel developments in accounting and reporting guidelines for Islamic financial institutions that took place during these years. These developments to a large extent stem from the same need to have financial solutions that are compliant with Shariah principles and have supported the developments on the takaful insurance front.

A possible roadmap for developing takaful market in India

From the above it could be deduced that the following needs to considered while drawing a roadmap to develop a robust takaful market.

1. Developing the regulations and supervisory oversight guidelines to allow takaful companies.
2. Develop in parallel other financial instruments that are Shariah compliant.
3. Develop in parallel accounting and reporting guidelines.
4. A gradual approach to allowing takaful operators while putting in place Shariah Compliance oversight body and market conduct regulations.
5. Strengthen the market by allowing international operators to provide takaful and retakaful products and funds, capacity and expertise to the local market.

3.2 *Demography of Muslims in India – key features*

Muslim share of the population

Muslims constitute the second largest religious group in India and thus the largest religious minority. India's Muslim population is amongst the largest in the world, exceeded only by Indonesia's and close to the Muslim populations of Pakistan and Bangladesh. The 2001 census enumerated India's Muslim population at over 138 million which was about 13.4% of the total population then. By 2006 the Muslim population was estimated to be over 150 million.

The fertility rate as an indicator to population growth

The Total Fertility Rate (TFR) which represents the number the number of live births a woman has on an average during her lifetime, if she goes through the reproductive span, following a given age-specific fertility schedule , is the highest for Muslims than other socio-religious communities in India. Other measures of fertility such as the crude birth rate (CBR), estimated from Census figures is also higher among Muslims (30.8, against 25.9 for the total population and 24.9 for Hindus). In addition, Muslims have lower levels of infant and under-five mortality than other Socio Religious Communities in India.

Muslim population is younger than average

The 2001 census made available tabulations on age by religion and Muslims show a relatively younger age distribution which is notably different from the general population. While 23% of the total population is of below 10 years in age, 27% of the Muslim population falls in this range. Further, in the age group 10-14 years the difference between the age distribution is in excess of two 2% for Muslims (14.7%) as compared to the national (all religions) figure (12.5%). A younger age distribution is an indication of a lag in population growth decline. The share of the elderly (65 and above) is not high, both for the general population as well as the Muslim population, and thus old age dependency is quite low. This probably indicates that there is a substantial scope for insurance for protection of the large juvenile population.

In conjunction with the earlier points, it may be deduced that Muslims are currently a growing segment of the population and hence there may be more Muslims at the insurable ages than those of other socio religious communities, thus indicating that potential size of the natural market for Takaful products is expanding.

Urbanisation in Muslim population is higher:

The level of urbanisation among Muslims has been higher than the population as a whole. In 1961, while overall only 18.0% of the population lived in urban areas, 27.1% of the Muslim population did so (Fig. 3.8). This substantial gap has persisted, and in 2001, 35.7% of the Muslim population was urban compared to 27.8% of the over all population. By and large, India's Muslim population is less linked to land than the overall population. This is true even in rural areas. The 2001 census data show that whereas among all religions, 40 percent of rural workers were cultivators, among Muslims this figure was only 30 percent (as seen from the tabulations in India, Registrar General, 2004). Agricultural workers (cultivators and agricultural labourers combined) constituted 75 percent of rural workers overall but only 60 percent of Muslim rural workers. This indicates that a substantial part of the Muslim population will be easier to reach out to as the urban distribution network has better infrastructure and access compared to the rural network.

Economic status

According to the Sachar Committee report, an investigation into the economic and employment conditions of the Muslims reveals that they are, by and large, a part of the less wealthy sections of the society. Most of them are self-employed and engaged in trade or employed in small scale enterprises. In Public or Private enterprises they are mostly employed in the lower grades. Also the report indicates that 31% of Muslims are classified as poor as compared to the national average of 22.7%. The report mentions that access to and size of credit among the Muslim community is very low compared to other socio religions communities. In contrast to this, the report mentions that the average deposit amount per account in Banks for Muslims was very close to the national average.

3.3 *Estimate of Takaful market in India (based on 2006 data)*

In order to estimate the potential size of the Takaful market in India the following (crude) approach was adopted.

- Muslim population was estimated to be 13.4% of the total population – the same level as in 2001 census
- GDP from this population was derived using the per capita GDP for the total population – considering the findings of Sachar committee, especially on the economic status of the Muslim population, various % of total GDP was applied on the estimated Muslim population size to arrive at a range of values
- Using the estimates of life insurance penetration up to March 2007 and assuming different % of the insurance penetration figures (to allow for possible under penetration in the Muslim population), a range estimate was calculated.

The above method provided a range of USD 2.78 billion to USD 4.95 billions as an estimate of the potential size of Takaful market in India, which is about 7.5% to 13.3% of the total estimated life insurance premiums up to March 2007.

As with any crude estimate, we request to treat these estimates with utmost caution. The most crucial parameter in this estimate is the level of insurance penetration that can be achieved in the Muslim population. The key factor that will affect the (yet unknown) penetration levels would be how effective the marketing of Takaful products could be in bringing in lives which hitherto were not touched by insurance products.

3.4 *Estimate of mortality differential of Indian Muslim population from the total Indian population*

There is no direct information available on the insurance and mortality aspects among the Muslim community. It is not clear whether the information pertaining to socio-religious community is captured by insurers.

Historically though, and without any comment on the relevance of the information today, during the investigation into the mortality of Indian insured lives of Oriental Insurance Company during the period 1925 to 1935 by L.S. Vaidyanathan, a study was also made into the relative mortality of Mohammedans, Christians and Europeans and comparisons were made to similar investigations in the previous periods. This report was published in the Journal of Institute of Actuaries JIA 70 (1939) 0015-0059.

It is interesting to note that in the above study the proportion of policies on Muslim lives accounted for 8% of the policies considered during the study and that the mortality of the Mohammedans was found to be 96% of those of the Hindus.

Due to the lack of recent information, reference has to be made to population mortality and other indicators. The following information is available from the Sachar Committee Report and other studies quoted by the report

- The infant and child (up to age 5) mortality is lower in Muslims compared to other socio religious communities, despite the fact that the economic status, nutrition levels and education levels are low compared to those of other communities.
- Higher proportion of the Muslim community in urban areas – which could mean lighter mortality rate
- Better fertility rates (as a proxy for good health of females) and lower maternal mortality
- A comparison of the life expectancies computed for Hindus and Muslims from the pooled data of NFHS1 and NFHS 2 Surveys indicated that the life expectancy of Muslims was on an average higher by 1 year. The study also revealed that the maternal mortality was lower among Muslims.

On the basis of the above findings and assuming a flat 3% discount on Muslim juvenile mortality rates, a rough computation of the effect of these on the age specific mortality (Crude death rates) reveals that the mortality rates for ages beyond 17 years of the Muslim population is on an average 8% lower than the all community mortality rates.

Several adjustments need to be made to these estimates made on population statistics to derive appropriate mortality rates for pricing and valuation purposes. Further discounts on population based mortality rates among others would depend on any class selection that could be achieved through marketing channels, product focus and the targeted customer segment within the Muslim community.

Section 4

4 Appendix

4.1 *Takaful Interest Groups*

AAOIFI - Accounting and Auditing Organization for Islamic Financial Institutions - www.aaoifi.com

AAOIFI was registered on 27 March 1991 in the State of Bahrain (Kingdom of Bahrain, now) as an International autonomous not-for-profit corporate body. AAOIFI is responsible for developing accounting, auditing, ethics, governance, and Shariah standards for the international Islamic banking and finance industry. In addition, AAOIFI contributes significantly to the professional development for the industry. AAOIFI is supported by over 160 institutional members from around 40 countries. It has its corporate office in Kingdom of Bahrain.

IFSB - Islamic Financial Services Board – www.ifsb.org

The IFSB, based in Kuala Lumpur, was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. It serves as an international-standard setting body of regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital market and insurance. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing international standards consistent with Islamic Shariah principles, and recommend them for adoption. To this end, the work of the IFSB complements that of the Basel Committee on Banking Supervision, International Organization of Securities Commissions and the International Association of Insurance Supervisors.

The 137 members of the IFSB include 35 regulatory and supervisory authorities as well as International Monetary Fund, World Bank, Bank for International Settlements, Islamic Development Bank, Asian Development Bank, and 97 market players and professional firms from 22 countries.

GTG – Global Takaful Group – www.globaltakafulgroup.com

The GTG is the successor of the ASEAN Takaful Group, (ATG) was formed on 28 October 1995 as in informal body or association to enhance greater mutual co-operation among takaful operators in ASEAN. In order to accommodate memberships from outside ASEAN region, ATG amended its constitution on 6 Oct, 2003, and formally changed to "Asian Takaful Group" . Today it has expanded to 23 members from Asia and the Middle East, and continues to receive enquiries from many players to be a member. It was later agreed that the informal grouping be registered as a legal entity by incorporating it as a company limited by guarantee in Labuan and renamed "Global Takaful Group" (GTG) .

OIC – The Organisation of the Islamic Conference – www.oic-oci.org

The OIC located in Jeddah, Saudi Arabia is an inter-governmental organization with a Permanent Delegation to the United Nations. It groups 57 nations, most of which are Islamic, in the Middle East, North, West and Southern Africa, Central Asia, Europe, Southeast Asia, South Asia and South America. It is the second largest international organization after the United Nations, aiming to "to promote solidarity among all Islamic member states."

Membership:
- Member
- Members once temporarily suspended
- Withdrew
- Observer
- Attempted to join but blocked

International Islamic Fiqh Academy - http://www.fiqhacademy.org.sa/

The Islamic Fiqh Academy is an Academy for advanced study of Islam based in Jeddah, Saudi Arabia and a subsidiary organ of the OIC. It was created at the decision of the second summit of the OIC in 1974 and inaugurated in February 1988. One of his main objectives relevant to this paper is *"To draw inspiration from the Islamic Shariah, to study contemporary problems from the Shariah point of view and to try to find the solutions in conformity with the Shariah through an authentic interpretation of its content."*

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