Takaful – Defining "Ethical Insurance"

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Abstract:

The interplay between religion and business is perhaps usually confined to the individual's moral standing and the level of ethics practiced by the individual in his business dealings. That is not to say that only the religious place importance on high moral standards and put ethics before profits. The legal principle governing commercial contracts has been *caveat emptor* (let the buyer beware) which basically encourages each party to get the best deal that he can, with minimal disclosure, without being misrepresentative. However, the level of sophistication associated with modern finance has clearly shown in the recent financial crisis that that concept has perhaps outgrown its time and that perhaps the concept of *uberrimae fidei* (utmost good faith) applies now not only in insurance but business in general.

This paper looks at the implementation of insurance within the restrictions placed on financing and commercial transactions by Sharia Law. It starts off by defining the parameters within which the religion, Islam, places the interaction between parties involved in a commercial transaction and goes on to explain how Takaful has been implemented to date and the challenges its practitioners face within the constrains imposed by the nature of the risks undertaken and the need to comply with Sharia Law.

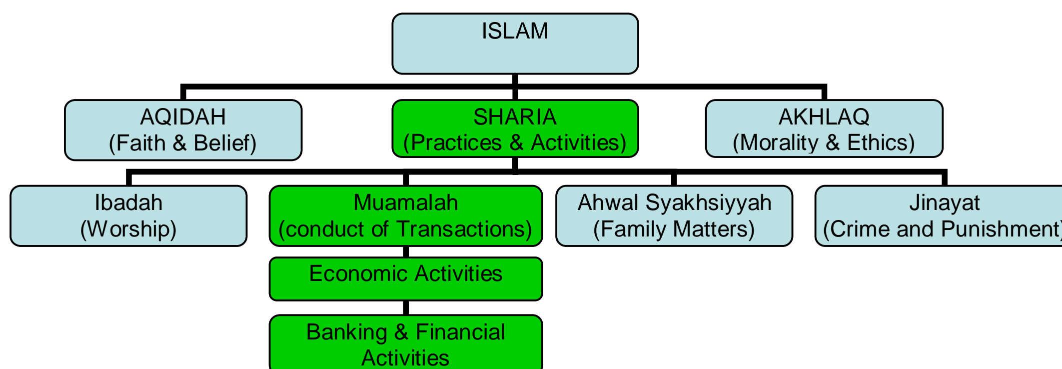
Keywords: Ethical Insurance; Mutual; Sharia Law/Jurisprudence; Islamic Finance; Evolution of Takaful; Farmers Exchange; Friendly Societies; Corporate Governance

Sharia Law/Jurisprudence

Islam can best be defined as a Way Of Life for its adherents, the Muslims. As such the religion does not stop at just defining the relationship between man and his God but also sets out clear guidelines as to how men should interact with each other. It is the set of divine rules outlining these relationships that defines Islamic jurisprudence *(fiqh)*. These rules have arisen primarily from the interpretation of the *Quran* (the Muslims' Holy book that sets out the literal words from, and final revelation of, God) and the *Sunnah* (a compilation of sayings and practices of the Prophet Muhamad whom Muslims believe is the last in the line of prophets descended from Prophet Abraham). The Sharia Law is derived from this interpretation and is comprehensive[i] .

There are Sharia laws relating to crime and evidence, commercial transaction, marriage, divorce and inheritance, religious practices, ethics and dietary rules, amongst others. The rulings handed down by Sharia scholars can be conflicting and diverse for two primary reasons. Firstly, there can be differences in interpretation of the *Quran* and the *Sunnah*. It must be clarified that these sources provide only basic concepts (out of the 6,666 verses in the *Quran*, less than one tenth relate to law and jurisprudence) and the Sharia can extrapolate on these concepts to resolve contemporary issues. With such extrapolations, divergence in opinions between Sharia scholars is inevitable. Secondly, there is the overriding rule of extenuating circumstances (*darurat)*. The true Islamic order means keeping strictly to the Islamic law as presented from an interpretation of the *Quran* and the *Sunnah*. However, Islam also sees itself as a practical religion and does allow concessions where necessary in extenuating circumstances. This would result in a temporary suspension or partial implementation of Islamic Law. As a result of differences in interpretation and application of the concessions, there can be seriously conflicting *fatwas* (rulings) between different Sharia scholars.

The figure below dissects how Islam affects the Muslim Way of Life;



Source: Islamic Banking and Finance Institute Malaysia

As it relates to Takaful the reader needs to be mindful only of the green boxes and the importance placed on good ethics in the conduct of commercial transactions.

As such, Takaful should not be seen as for Muslims only as *Aqidah* (which defines one's faith and belief) is not an integral part of Takaful and the practice of Takaful promotes universal ethical values which are present in other religions and society at large, rather than just Islam.

The Generation of Economic Value within the Rules set out by Sharia

Takaful is not a charity, it is commerce. If one were to encapsulate the underlying principles of commerce as promoted in Sharia Law in one sentence, it would be that profit should come through effort and the assumption of risk on the part of the individual, not merely through the ownership of capital. This principle can be seen in the Sharia's prohibition of charging interest on money on loan[ii]. In the conduct of insurance, the ability to underwrite is empowered by the underwriter's access to unencumbered capital. The shareholders of the insurer exact a return on capital through the process of putting capital to work by underwriting risk. However, rather than expecting a fixed return on capital as is available in a fixed coupon security held to maturity, the ultimate return in the insurance process is also dependent on the underwriting experience. Indeed the innovation that brought about catastrophe bonds is the securitisation of this process in particular.

It is without a doubt that the ability to transfer risk, through an insurance policy, and the availability of a vast web of reinsurers have allowed risks to be disseminated globally. The paper will discuss later on the practicality of implementing the underlying Takaful concepts in place of existing insurance arrangements for various types of risks.

Any business transaction must be accompanied by an agreement, a document which spells out the contractual rights to all parties in the transaction. What constitutes a Sharia compliant commercial financial contract?

For a contract to be acceptable in Sharia law it must satisfy certain conditions:

- No *Riba* (interest, usury)
- No *Gharar* (uncertainty)

- No *Maysir* (gambling)
- The parties to the contract are engaging in permissible *(halal)* dealings and avoid prohibitive *(haram)* dealings.

These conditions would mean that the fundamental principle of Islamic Finance is that the provider of capital and the user of capital should share the risk of any business venture. The concept of partnership, principally the various bases of sharing profit or loss i.e. equity financing, defines Islamic Finance. Thus, risks in a Sharia compliant business transaction would be shared rather than transferred and money used only as a medium of exchange and not treated as a commodity (which can be traded for profit i.e. debt, earning interest). Interest-based debt financing is expressively prohibited in Sharia Law. Insurance companies investing in interest bearing bonds would make such institutions not Sharia compliant.

The prohibition against *Gharar* can best be explained by considering a couple of examples;

- Sale of the unborn calf in the womb of a pregnant cow
  - There is *Gharar* present in the sale as the buyer and seller do not know whether the calf will be born alive and if alive, born deformed. Such a sale is not Sharia compliant.

- Sale of tomorrow's fisherman's daily catch
  - This is an advance sale of an unknown quantity of fish. Both the buyer and the fisherman do not know how much fish would be landed tomorrow or even if the weather tomorrow would permit the fisherman to go to sea. The presence of *Gharar* would invalidate any such sale from the Sharia perspective.

The prohibition against *Gharar* can be seen as an attempt to ensure that the sale transaction is fair to both buyer and seller by removing the possibility of exploitation by one party due to any asymmetry of information between the two parties to the transaction. In an insurance contract there are many elements of uncertainties involved. For example, the amount payable should the insured, event transpired can be uncertain and whether the event will happen during the period of insurance is also unknown.

A commercial contract should also not have any elements of gambling in it. Gambling can best be defined as taking on speculative risk, where speculative risk can result in two outcomes, either a profit or a loss to the risk taker, and where the risk taker has no or minimal influence on the final outcome. This is in contrast to pure risk where the event can only result in a loss. Insuring ones car against theft can be seen as managing a pure risk (and would not be seen as gambling as in the event of a loss he can only claim the monetary value of his car as that is his insurable interest) while the act of an insurer taking on the risk of the car being stolen for a premium can be seen as taking on a speculative risk.

The final condition imposed for commercial contracts to be Sharia compliant is the nature of the transaction itself. In the eyes of Sharia there are activities, professions and transactions which are explicitly prohibited *(haram)*.

- Examples of prohibited dealings are:
  - Transactions which can be harmful to the health and well being of the society. Examples of which include production and distribution of alcohol and tobacco.

- Transactions which are harmful to the environment. Islam promotes the preservation of the environment.
- Transactions which could harm the moral standards of the individual. Examples are embezzlement, stealing and production and distribution of pornographic materials.

Baring the prohibited dealings, all other activities, professions and transactions etc., are permissible *(halal)*. It can therefore be seen that Sharia Law promotes socially responsible activities. For an insurance company to be Sharia compliant it would need to adhere to restrictions on the businesses it can invest in.

Thus the generation of economic value in Sharia law is based exclusively on the concept that reward must be accompanied by the assumption of risk, and with risk management being restricted to risk sharing rather than risk transfer. This condition ensures that elements of accountability remain with the risk originators.

Evolution of Takaful

From the preceding paragraph, it is clear that conventional insurance is not Sharia compliant because of the following reasons:

(i) The insurance contract contains elements of *Gharar.*
(ii) Where it is a proprietary insurer, there are elements of speculative risk in the transaction as there is a transfer of risk from the policyholder (being the insured) to the shareholder (the insurer).
(iii) Assets of the insurance company include interest bearing securities.
(iv) Portfolio investment includes investment in companies involved in Sharia prohibited activities (e.g. interest based banking, gambling conglomerates, tobacco companies etc).

The Islamic *Fiqh* Academy (the Academy) is an academy established,by the Organisation of Islamic Conference,(OIC) for the advancement of studies of Islam. The Academy's Resolution no. 9 made in the year 1985 formally ruled that conventional insurance is not Sharia compliant and sets two conditions for the establishment of a Sharia compliant insurance program:

(i) That the underwritten risks must be pooled among the insureds only, thus the insureds collectively are also the insurer (similar to a Mutual or Cooperative insurance society).
(ii) That the risk premium made by the members of the pool be treated as 'unilateral contributions' towards the pool.

The first condition avoids the elements of speculative risk in conventional insurance by making the arrangement one of risk sharing (among the participants of the risk pool) rather than a transfer of risk (from the insured to the proprietary insurer). This means that premiums are estimates of the ultimate cost of meeting claims with any surplus distributed back among the insured. The second condition is more subtle in its application. Notwithstanding that risks are now shared rather than transferred; there still remains the element of uncertainty (i.e. *Gharar)* in the process of risk pooling. Specifically, premiums are paid by the participants into the risk pool for which there is uncertainty as to what claims the pool has to ultimately pay, when such claims are to be paid, how much would be paid and whether the participant will be a claimant. To overcome this *Gharar* the Academy recommends that the risk

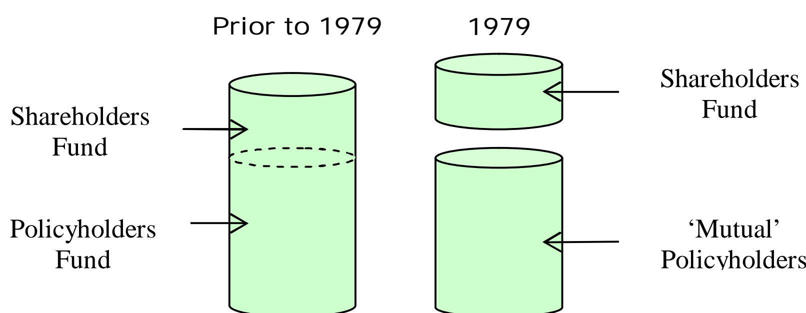
premiums be considered as *tabarru'*. *Tabarru'*, loosely translated, means donation (in the same context as you may donate a sum of money towards your *alma mater*). A better definition in the context of a sharia compliant insurance program is to term the risk premiums as "unilateral contributions", under which the participants relinquish their rights to determine the use of the risk premium. It has to be a unilateral transaction as, if it was a bilateral transaction the contract would not be Sharia complaint due to the presence of *Gharar*.

These two pre-conditions set the formal ground work for modern Takaful. However, one important operational aspect required of any insurance program was not directly addressed by the Academy. That would be how the risk premiums should be determined. There are two bases of premium determination, community rated or risk factor rated. That choice is left to the manager of the risk pool. The application of Sharia Law works on the principle that whatever is not expressively prohibited *(haram)* by Islam is acceptable *(halal)*. In practice, the process of determining the risk premium in Takaful is consistent with that of conventional insurance programs, i.e. risk factor rated.

There are difficulties in setting up Mutuals on a commercial scale and making it profitable within an acceptable time frame. Sudan and Malaysia took different routes in their approach to this problem.

The Sudan approach

Sudan was fundamental in its approach. In 1979 (six years before the Academy's ruling), the government declared that all insurance companies in Sudan are required to convert to Takaful. The underlying business model before then was primarily proprietary insurance, with a shareholders fund providing the required minimum statutory capital and dividends determined for shareholders by the investment performance of total funds (shareholders and insurance) and the company's underwriting results. This changed overnight; shareholders were reduced to being entitled to only the investment return on the now segregated shareholders fund while the entire underwriting surplus plus the investment return on insurance funds are now due to policyholders. All operating expenses (management plus distribution costs) are charged to the policyholders' fund.



There were three other fundamental changes that took place. First and foremost, each Takaful company is required to have its own Sharia Advisory Board (SAB). This entity is separate from the Board of Directors. Its function was to guide the company to ensure that its operation is Sharia compliant. The business decisions remain the responsibility of the Board of Directors, but with the SAB reviewing the implementation of those decisions to ensure Sharia compliance. The second change was the requirement to have either one or two policyholders' representative on the Board of Directors, elected through a special annual

policyholders' general assembly. Finally, all investments of the Takaful company have to be screened to ensure they are Sharia compliant.

The Malaysia approach

Malaysia's approach to Takaful was more structured. The government's aim is to create an Islamic financial system parallel to an already well established conventional financial system in the country. The intention is to give a choice to the public as to which system to use and also to complement rather than replace the already well entrenched conventional system. Towards this aim, the Regulators introduced a Takaful Act, established by an Act of Parliament in 1984. Through this Act the first Takaful company, Takaful Malaysia, was established. Interestingly, only one Takaful license (a composite) was initially issued. Like the Sudan operating model, the company has a shareholders fund which is also segregated from the policyholders' fund. Unlike the Sudan Model all management and distribution costs are paid out from the shareholders' fund. The company also has its own SAB that functions to ensure the company's operation is Sharia compliant. However, there are no policyholders' representations on the Board of Directors nor is there a requirement for an annual policyholders' assembly.

Thus as we can see, both the Sudan Model and the Malaysia Model are not strictly Mutuals, but instead are hybrids. Between the two the Sudan Model is the closest to being operated on a Mutual basis, the presence of a shareholders fund notwithstanding.

Takaful as a Commercial Entity

Obviously if Takaful were to be run purely as a Mutual there will be no explicit profit motive in its operation. For Takaful to be run on a commercial basis and be Sharia compliant, modifications to the basic Mutual model are required. That came through the adoption of the Agency operating model in the later Takaful set ups. But before this operating model became predominant among Takaful set ups, the pioneers of Takaful experimented with a Profit Sharing Model. Under this model, instead of the shareholders being entitled to a fee (as under the Agency operating model), the shareholders are entitled to share in the profit generated by the business.

Sharia Compliant Contract Types

At the time Islam was established in the 7th century AD, business and trade in the Arabian peninsular had already adopted the concept of contract 'type' as the legal basis for bilateral transactions. Each type of contract had a specific meaning and once an agreement was reached as to the type of contract to be used, the method of compensation was clearly defined and all that remained was to determine the level or quantum of compensation. This method of establishing a contractual relationship through contract types is rather different from what one would normally expect but is nonetheless equally efficient.

Contract Types

As established earlier in this paper, the basic principle of trade and finance from the Sharia jurisprudence perspective is the sharing of risks. In a business arrangement there is the capital provider, the entrepreneur (which can also be the capital provider), the wage earner and the user/consumer. The contract types can be used to define the nature of the agreement undertaken by any combination of these four parties, with the prohibition of charging interest

on loans automatically excluding interest charging creditors as a party in business and without them a reduction in the ability to "gear" profits.

The common contract types used in Islamic Finance are:

(i) The *Musyarakah* Contract
(ii) The *Mudharabah* Contract
(iii) The *Murabahah* Contract
(iv) The *Ijarah* Contract
(v) The *Wakala* Contract

The *Musyarakah* and *Mudharabah* contracts are Shariah compliant modes of financing, while *Murabahah* and *Ijarah* are sale and services contracts respectively which have been adapted by Islamic banks as alternative modes of financing.

Three of the above contract types are briefly explained below.

The *Musyarakah* Contract

The *Musyarakah* Contract is pure equity based financing. Two or more parties provide capital in an agreed percentage and profit and losses are shared in an agreed proportion (not necessarily in proportion to the equity provided). This is effectively a partnership between the capital owners. Interestingly such partnerships were not intended to be limited liability in nature. Its modern day adoption, however, is in the form of limited liability company/ partnerships.

The *Mudharabah* Contract

The *Mudharabah* Contract is a partnership between a capital provider and an entrepreneur. The former provides capital while the later provides the knowledge/manpower to conduct the business. In the venture, the entrepreneur is not allowed to charge his own wages/expenses in running the business to the capital while the capital provider does not interfere in the business process. The entrepreneur's reward would be an agreed share of the profits derived from the venture. This share of the profits would go toward defraying his wages/expenses. Any losses however, are borne solely by the capital provider to the extent of the capital provided. The entrepreneur by virtue of already having contributed his knowledge and manpower to the enterprise which were not charged to capital loses in that his effort would go unrewarded should the venture fail.

The *Wakala* Contract

The *Wakala* Contract is equivalent to an agency agreement, under which a principal contracts an agent to perform a range of services. Under this contract and in return for a fee (expressed either as a percentage of some consideration or as a fixed amount) the agent provides a predetermined service.

As mentioned earlier, Sharia Law lays down conditions as to how bilateral transactions should be conducted. The above contract types were already in existence before the advent of Islam and were subsequently accepted as Sharia compliant. Contrast this with the charging of interest on loans which was initially allowed to continue when Islam was first established, but by the time the revelation of *Quran* was completed (the *Quran* was revealed over a time span of over 22 years), the charging of interest on loans was strictly prohibited.

There is nothing to prevent practitioners of the religion to come up with new contract types as long as the conditions mentioned earlier are adhered to. This, however, has not happened and Islamic Finance and Takaful continue to use and adapt these existing contract types (and there are others not mentioned in this paper) in conducting business.

Application of contract types in Takaful

The Sudan Model was effectively a Mutual with a shareholders capital in tow. In recent years the Sharia scholars in Sudan approved an enhancement to the business model whereby the task of investing the insurance funds can be contracted out to the shareholders fund (which as stated earlier is segregated from the policyholders' funds), on the basis of a *Mudharabah* contract. Two conditions were imposed, firstly that the expenses related to the establishment and running of the unit responsible for investing the funds have to be borne entirely by the shareholders fund. Subsequently any investment profits would be distributed between the shareholders fund and the policyholders fund at pre-agreed rates. Secondly, the shareholders are responsible for any loss attributed to negligence in investing the insurance funds.

On the other side of the world, Takaful Malaysia improvised its interpretation of the *Mudharabah* contract. It deemed that premiums into the risk pool are considered as capital, and surplus (which include underwriting and investment profits in excess of the rate used in pricing, if any) are considered profit. This "profit" is shared between shareholders and policyholders based on agreed, predetermined percentages. This model resulted in;

(i) No income to shareholders (and thus leaving expenses unrecovered) when there are no surplus/profits in any year.
(ii) High initial premiums as the company need a sufficient buffer to ensure that a surplus will indeed emerge.
(iii) No policyholders representation on the board of directors as capital providers in the *Mudharabah* contract should not interfere in the running of the business.

The application of the *Mudharabah* model worked reasonably well under certain conditions:

(i) Salaried based distribution channel. An agency based distribution network with the requirement to pay a fixed percentage of the premium would not work as there is no certainty that a surplus will emerge. Salaried based distribution of course has its own challenges.
(ii) Yearly renewable type products. This includes group life, property and casualty type short tail business. Such products allow 'profits' to be determined quickly.

The major drawbacks of the model would be apparent in that the difficulties in predicting an income stream to shareholders make business planning a challenge, the absence of agency networks make expansion difficult and last but not least, long term life products with its accompanying new business strains meant that the emergence of surplus would be deferred. Nonetheless Takaful Malaysia prospered and this can be partly attributed to the fact that it was the only takaful company in Malaysia for nearly ten years. The *Mudharabah* model does have one very significant advantage and that is it aligns the interest of shareholders very closely to that of the policyholders and if properly executed, it has the ability to provide an attractive return to policyholders.

Notwithstanding the technical challenges, the Takaful Malaysia operating model also has Sharia issues. It was challenged by a majority of Sharia scholars outside Malaysia, as to its

compliance. The concern arises from the interpretation of surplus as profits. To these Sharia scholars, profit is defined as the excess of that derived from investing a dollar of capital. The residual amount available after paying claims is not profit and as such they conclude the *Mudharabah* contract cannot be used for this purpose.

Present day Takaful

The overwhelming majority of the Takaful companies now use the *Wakala* contract as the main contract in their Takaful model. There are the 'Mutual' policyholders' funds (there can be more than one policyholders' fund when different risks are segregated) and the shareholders operating fund (the Operator's fund).

The policyholders fund contracts out the administration, investment, underwriting and distribution functions to the Operator's fund in return for a predetermined fee. Any surplus arising in the policyholders funds are distributed either as a cash refund or as a reduction in the renewal premium.

How then are the fees determined?

In practice two methods are used. The more common practice is to fix the fee based on the marginal cost of running the business' various functions plus a profit margin for the shareholder. Of course there will be market considerations as to ultimately what these fees are as they will be clearly set out and disclosed in the policy contract. These fees are fixed for the duration of the policy.

The second way (and this works only for yearly renewable contracts) is for the fees to be determined and announced yearly by the Operator. Thus, at the beginning of the financial year the fees are fixed by the Operator for policies in force in that year. This allows for the fees to be varied depending on the expected expense and profitability of the policyholder fund.

What happens when there is a deficit in the policyholders' fund?

Where a deficit arises, the Operator is obliged to extend a loan (*qard*) to the policyholder fund. This loan can be considered as a form of subordinated loan (there are Sharia issues related to this arrangement in that a *qard* cannot be enforced and in a winding up according to Sharia law, all creditors rank equally). The loan would need to be repaid from future surpluses of the policyholders' fund. Indeed there will be no distributions of surplus to policyholders until the loan from the Operator is fully repaid. The loan must also be interest free, *Qard Hasan,* benevolent loan.

Applying Takaful to various risks

In Malaysia, where Takaful has been in existence for over 25 years the Life Takaful (termed Family Takaful) has been the more successful type of Takaful. This can be attributed to many reasons, among them:

(i) the rapid growth of Islamic banking in Malaysia and the ensuing growth in Sharia compliant consumer loans for mortgages meant that 'credit' related Takaful products are very much in demand.

(ii) the high savings rate in Malaysia provided a source of funds from which Takaful Operators were able to tap.

(iii) the growth of the Sukuk (Islamic bonds, over 50% of the outstanding Sukuks in the world originates from Malaysia) market in Malaysia allowed long term Takaful contracts to be reasonably priced.
(iv) a well developed agency and bancassurance distribution network for conventional insurance which could be readily tapped for Takaful.

Term type Takaful products require that the bulk of, if not all, the Takaful premiums less the Agency fee to be deemed as *tabarru'*. While for savings type products only that portion required to meet the mortality contingent need to be so assigned. The remainder of the premium is allocated to individual accounts and is invested in Sharia compliant assets. The amount is accumulated in what is deemed the policyholder's account and is payable at maturity or earlier mortality. The investment risks rest with the policyholders while the mortality risk is borne collectively by the policyholders through the Takaful risk pool. This arrangement is not unlike the Universal Life product available through conventional insurers but with no guaranteed "floor" crediting rate. Another successful variation of this product structure is to use the premium less the Agency fee and the *tabarru'* amount to buy units in unitised investment pools very similar to the conventional investment linked products.

It would be noted that all Takaful products are participating by nature, even term products. For term products there would invariably be a residual amount at the end of the policy duration which would constitute a share of the surplus arising during the term of the policy. Another unique feature of Takaful is that the prohibition against *Gharar* permeates even the product design itself. For example, a whole of life policy is not possible in takaful as the policy term is uncertain. A whole of life takaful policy would normally be structured as a takaful endowment to age 100.

Risk sharing is in line with the concept of insurable interest and insurance being a contract of indemnity. While in Non Life Takaful the concept of indemnity is easily applied, this is not so clear cut for non credit related Life Takaful. Suffice to say that over insurance on ones life is not Sharia compliant!

The recurring theme in Life Takaful products is that there is no guaranteed return on the accumulated savings. This is consistent with the absence of guaranteed return Sharia compliant investments. The Takaful Operator can provide a guarantee overlay on the takaful plan but then has to be content with the Sharia restriction that other than to charge a fee to recover administrative expenses incurred in processing the guarantee, it cannot charge for the guarantee itself. This restriction makes the provision of a guaranteed investment return in Takaful impracticable.

The question that may be asked is how the performance of Sharia compliant equities compares with other equities. There can be significant divergences in performance between a pool of Sharia compliant equities and the unrestricted universe which can be linked to the nature of the Sharia qualifying investments themselves. During the global Telecom boom, for example, Sharia compliant equity indices underperformed as the absence of telecom stocks (due to the usually high gearing, telecom stocks are not Sharia compliant) weighed down performance, conversely in the recent financial sector blowout Sharia compliant equity indices would outperform due to the absence of banks and insurance companies in their portfolio.

In Malaysia some 40% to 45% of its population are non Muslims and by experience, 30% to 40% of Takaful policyholders have been non Muslims. This reflects the general acceptance of Takaful among the non Muslims in Malaysia. Indeed the growth of the Life insurance industry in Malaysia in recent years can be attributed to the contribution to the National total Life insurance premiums from Takaful as the previously uninsured population take up Takaful and as conventional life insurance cedes market share to Takaful.

The success in Life Takaful can also be attributed to certain technical factors. The concept of sharing of risks works well when claims are relatively predictable (as they are with life insurance). This limits the demand for interest free loans from the shareholders fund to fund any takaful pool shortfall. It also allows regular surplus to emerge which in turn makes the products more attractive to policyholders.

The growth of Non Life Takaful has not been as successful as that for Life Takaful in Malaysia. Perhaps this can be attributed to that fact that all Takaful operating licenses to date have been composites. It has been proven by experience how difficult it is to give equal management attention to life and property and casualty business (P&C) within one company.

But there are also other reasons why Non Life Takaful has not been as successful. First and foremost it goes back to the need to limit claims volatility. In many P&C classes of risk, there remains a significant level of claims volatility. Takaful companies which underwrite such risks use reinsurance (dispensation is given to use reinsurance where retakaful is not available) or retakaful to mitigate the claims volatility, which can have repercussions on the level of profit sharing possible. Another reason is that over 70% of the net (of reinsurance/retakaful) risks in Malaysia are motor related and motor insurance in Malaysia is tariff driven and a difficult class to underwrite.

Learning from history

The concept of Mutuality in insurance is not new. The origins of insurance can be traced to Mutuals providing for groups of individuals faced with similar risks, pooling their resources to assist members who are in need. It is interesting to note that of the top ten Life and Health insurance companies globally four are Mutuals , whilst there was only one Mutual in the top ten ranking of P&C Insurers (Source FORTUNE GLOBAL 500 2009 http://money.cnn.com/magazines/fortune/global500/2009/index.html). This can perhaps be traced to the participating nature of life savings policies where the absence of shareholders result in higher returns to policyholders (assuming the performance of assets under management is not influenced by the ownership structure of the company) as there is one party less to share profits with.

For P&C business, the sophistication required for underwriting and the greater volatility expected from claims experience (resulting in greater capital requirement) make proprietary based insurer a more natural candidate for success. Profit sharing is furthermore usually not a consideration for buyers of P&C cover as the commoditized nature of the offering makes pricing a strong determinant of the choice of carrier.

All this tend to suggest that the structure of Takaful is better suited for life/savings type products rather than P&C products. That notwithstanding, personal lines P&C offerings share similar traits to life products and can be a profitable avenue for Takaful to exploit.

The Farmers Insurance Group experience

It may come to some surprise to the reader that there is already a quasi Takaful set up operating successfully for decades in North America.

The Farmers Group Inc. dba Farmers Underwriters (FGI), act as Attorney-in-Fact to the Farmers Exchange (consisting of three reciprocal insurers the Farmers Insurance Exchange, Truck Insurance Exchange and Fire Insurance Exchange) which are owned exclusively by their policyholders. As a management company, FGI (owned by Zurich Financial Services) manages the policies under the Farmers Exchange. FGI provides non-claims related management services to the Farmers Exchange in return for a fee determined as a percentage of the gross premium. These non claims related services extend to risk selection, preparation and mailing of policy forms and invoices, premium collection, management of the investment portfolios and certain other administrative and managerial functions. Farmers Exchange remains responsible for the claims function including the settlement and payment of claims as well as the payment of agents' commission and bonuses. This arrangement allows Farmer's Exchange to retain control of its relationship with members and the distribution force, the two critical relationships in any insurance set up. Interestingly the management services agreement is direct between the policyholder and FGI as the policy contract sets out the role of FGI and the management fees payable to FGI. FGI also gets to participate in the underwriting results of Farmers Exchange through its subsidiary Farmers Re through a 25% quota share agreement, with a limit on profitability through a ceding commission arrangement, and a supplementary performance related fee.

In addition to the Managed Care Services Agreement and Reinsurance Agreement, Farmers Exchange has separate Investment Management Agreements with external service providers.

Similar to loans from Takaful shareholders to cover deficits in the Takaful risk pool, there is also provision for Farmers Exchange to issue bonds to FGI and other external parties, which contribute towards boosting Farmers Exchange's solvency margin. These bonds are termed either Surplus note certificates (if they are not issued to affiliates) or Contribution certificates (if issued to affiliates). These certificates have a fixed term and carry a coupon. They are different to ordinary bonds in that interest and capital payments are subject to the availability of surplus in the policyholders' pool and are also subject to the agreement of the Regulators. As a proactive step to further ensure solvency, Farmers Exchange issues contingent Surplus note certificates where lenders are obliged to subscribe on pre agreed terms on the happening of a contingent (for example when the reinsurance lines of protection are exhausted in the event of a catastrophe).

Farmers Exchange writes most of the property and casualty lines of business with a heavy emphasis on personal lines, homeowner and auto. According to A.M. Best Farmers Exchange was #3 in the personal lines property casualty group by gross premium written in the U.S. in 2007, proving that this operating model can be a success. With a profit margin of 7% of gross premium or nearly 50% of the Management fee (Zurich Financial Report 2008), this is also a success for FGI.

The Friendly Societies [iii] experience

Friendly Societies first started operating in the UK in the 18th century. There are two types of Friendly Societies, the unincorporated (no new Friendly Societies can be established under this basis since 1992) and the incorporated variety. In the case of an unincorporated Friendly Society a Trust is established which is governed by a Board of Trustees. The member of a Friendly Society is treated as a beneficiary under a trust with vested proprietary rights.

The modern Friendly Societies are focussed towards providing financial services for their members. Furthermore policyholders and are no longer linked by common needs nor are the Societies required to provide benevolent services as they had been organized in the early years.

Friendly Societies compete on the basis of tax free investments, low charges and consequently higher returns than available under conventional participating products and balanced managed funds (Money Management April 2009).

The continuing success in attracting new members (5.1 million members in 2008, according to the Association of Friendly Societies 2009 key statistics 2009, an increase from 4.8 million in the preceding year) implies a continuing interest in the Mutual approach to providing for life insurance and savings needs.

Like Takaful, Friendly Societies can contract out administration services to external service providers for a pre agreed fee. However, unlike Takaful as it is currently established, these external service providers can be replaced should the Trustees so decide. This significantly improves the level of corporate governance as, in addition to independent Trustees who are responsible for the policyholder funds, there is competition in the provision of administration services. Furthermore one service provider can be manager to more than one Friendly Society.

Corporate Governance

The Mutual ownership structure eliminates the owner-policyholder conflict by merging the ownership and policyholder functions.

However, this ‘benefit’ is not necessarily present in most Takaful Operations due to its hybrid nature. Indeed the nature in which the shareholders are remunerated can affect the strategic direction of the company. Under the Wakala model where shareholders are entitled to a fee income which is determined as a percentage of premium income, the drive to maximise this income has resulted in some circumstances to the under pricing of risks to the detriment of the solvency of the policyholders fund. This is obviously a very short term view of the business as the increase in the volume of business will subsequently be overtaken by losses in the policyholders’ fund. The need for the Takaful Operator to provide interest free loan to cover the resulting deficits and perhaps subsequently to even write off these loans when its recovery become doubtful, would more then offset any initial gain in shareholders revenue. Perhaps to offset this risk, the regulator in Malaysia has allowed the Takaful Operator to have a share in the underwriting surplus of the policyholders fund (subject to that share not being greater than the policyholders share) as a performance fee. However, the sharing of underwriting surplus but not in underwriting losses will give rise to other corporate

governance issues. For example the difficulty in annually estimating underwriting surplus or loss in certain classes of risks (e.g. liability) can turn an initial underwriting surplus to subsequently, when all claims are reported and settled, an underwriting deficit. The *Sharia* community itself is divided on whether the Takaful Operator should be allowed to share in underwriting surplus as this goes against the concept of Mutuality and dilutes the 'purity' of the underlying *Sharia* approved contract type (under the *Wakala or* Agency contract the agent should only be entitled to his fee, not a share of any surplus) between the Takaful Operator and the policyholders.

Another touted preference for Mutuals is their focus on customer service rather than only profits. In an agent-principal relationship such as Takaful, the agent may seek to maximise profit by minimising expenses which inadvertently can affect service to policyholder. How fees are structured would also favour the Operator as the policyholder would have no say on the fees payable other then to shop around. Finally how surplus is determined and distributed is also determined by the Operator. These examples of agent-principal conundrum are not easily resolved.

The long term sustainability of the hybrid Takaful Model is dependent on a successful resolution of these conflicts as managing conflicts through regulation is usually ineffective in the long run.

The hybrid operating model does present certain advantageous which can offset some of the challenges in corporate governance. The stock ownership structure of the Takaful Operator allows a better means of managing owner-manager conflicts. This would be done through the Board of Directors and clear directions as to performance targets and continuous monitoring of such targets. This can result in a more efficient Takaful Operation then had it been a pure mutual operation.

Conclusion

Risk is something that we face every day. Most of the risks we face are not fatal and in many instances only result in minor inconveniences. Risk management however, is now big business. The idea that risk could be divided and further subdivided and sold in pieces has its roots in reinsurance and is manifested in the financial world in the form of securitisation. It was taken to the extreme in the 2007/08 financial crisis with the idea that risks can be packaged and repackaged and distributed widely so as to ultimately "disappear" altogether. In truth however risks do not disappear but are instead replaced with other risks.

Insurance is a means of managing risks. Consumers in the past were content to accept that what they are paying to the Insurance Company to indemnify their risk was fair. This is changing as consumers become aware that there is no reason why buying insurance should be any different from buying a car, say, complete with warranty. Insurance institutions are changing in response to the rise in consumerism.

So is the insured getting a fair deal? The asymmetry of information between the insured and the insurer can question the fairness of the transaction. Is the insured fully aware of;

a) How much the insurer is taking for his expenses?
b) Has the insurer "priced" the risk fairly?

c) To what extent does the insured understand the financial strength of the insurer?

The institution that is the Mutual Insurer addresses some of this shortfall in that the ultimate "cost" of insurance cover, including the ultimate payment of benefits, is determined by the experience of the insurance pool itself. Yes, there is less certainty but there is no pretence of it being otherwise. In the conventional non Mutual model the cost associated with certainty of benefits may be too high for the consumer to pay and ultimately the guarantee lies not with the shareholders but with the taxpayers as the recent financial crisis has shown.

The hybrid that is modern Takaful clearly has issues to address, for example that of managing the agent-principal conundrum, that can be challenged as not being true to the spirit of Mutuality. For its practitioners the attraction of Takaful is the promise of access to and profiting from a new market and the opportunity to ride on the coattails of the fast growing Islamic Finance sector.

Not all risks are suitable for Takaful. Clearly big specialised risks require capacity which Mutuals would have a challenge in accumulating. Then again it is in personal lines that Mutuals have traditionally excelled and very likely that is where Takaful will find a natural home.

ENDNOTES

i Being an interpretation there can be variations among Sharia scholars on the same theme and this can partly explain the turmoil currently faced by the followers of Islam.

ii In the case of loans paying a predetermined interest stream and a guaranteed repayment amount, the owner of capital is assured a return with no effort employed on his part other than the selection of where to employ his capital and the price to be paid for the utilisation of this capital (which in turn is dependent on the general cost of capital for the duration of the loan and the level of security of repayment, rather than the expected return to be generated by the capital itself).

iii Friendly Societies; Mutual Insurance Associations in which members subscribe for provident benefits for themselves and their families