building value together

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Risk Management and Governance in Takaful

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Setting the scene
-the Stakeholders in takaful

- Investors
  - Responsible for market entry strategy
    - Takaful model of choice
    - Takaful products to underwrite/promote
  - Expecting to reap a specific return on investment
- Regulator
  - Responsible for orderly development of the takaful market
  - To grow a shariah compliant Islamic financial system
- Participants
  - Needs appropriate products in order to manage risks
  - Price and cover are usually the basis of selection of product

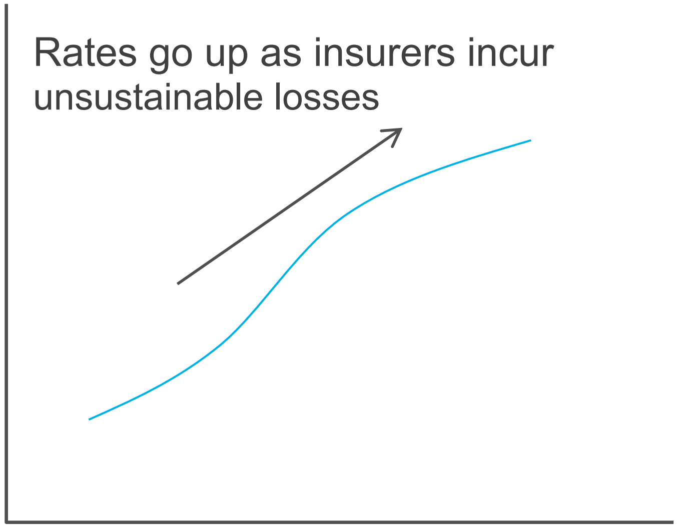
To manage risk effectively we need to understand what each of the above stakeholders expects from takaful

Where takaful differs from insurance

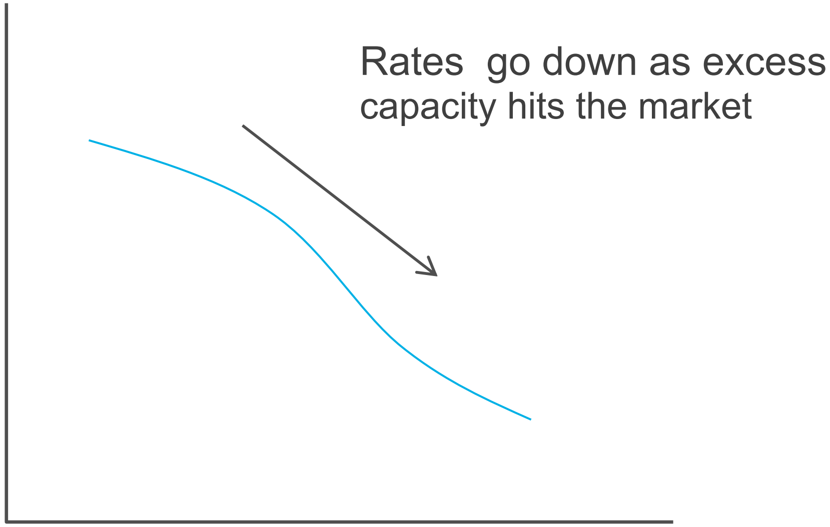
- Insurance works on the basis of competition, primarily price competition for the level of cover provided. Shareholders capital and retained profits provides the security that claims would be paid. In return for this assurance the shareholders expects to reap underwriting profits.
- Takaful works the basis of risk sharing. Participants in takaful however do not provide any capital to the risk pool. Therefore there is not necessarily a guarantee that all claims would be paid. Any interest free loan from shareholders of the takaful operator would allow the takaful pool to pay claims which may be greater then the premiums collected.

On the basis that takaful is conducted on a risk sharing basis the principal driver is not underwriting profits but instead service.
The principal driver for insurance is maximizing surplus (underwriting profit plus investment income)

Can takaful competes with insurance on the basis of price?
-the underwriting cycle



Opportunity to recover losses from previous downturn



Protecting market share through a strong balance sheet

Can takaful competes with insurance on the basis of price?
- accumulating operating reserves when rates go up

Sharing of income to the operator	Takaful Operator's share	General Insurer
Underwriting surplus	0% to 50%	100%
Investment income on technical reserve	50% (max)	100%
Expense underrun profit	Limited by *wakala* fees	100%

- Obvious from above table that insurer is able to accumulate reserves faster than takaful when rates go up as takaful operator needs to share surplus/investment income with participants.
- As general insurers are able to accumulate operating reserves faster than a takaful operator they are expected to be better placed to withstand a subsequent downturn in the underwriting cycle.

Takaful operators which competes head on with insurance on the basis of price is likely to fail.

Major risks and governance issues associated with takaful

- Takaful operation promising guaranteed benefits when there are insufficient capital to manage expected claims volatility and/or absorb losses.
  - In takaful there is no risk capital involved. The *qard* is a loan which the operator is obliged by regulation to inject into the participants risk pool should a deficit occur.
- Misalignment of the interest of the stakeholders.
  - Depending on the takaful operating model serious misalignment of interest can happen which puts the participants at a disadvantage and also affects the long term sustainability of the takaful operation.

Managing risk starts before the first product is sold as different approaches to takaful results in different inherent risks.

Holistic approach to managing risks and governance

- Appropriate screening of the suitability of investors in takaful.
- Determining the best takaful operating model for the market. Different operating model have different inherent risks which needs to be managed. Having a uniform takaful model in a market minimizes the risk of disrupting the market.
- Limitation on the appropriate takaful products to underwrite/promote based on the capability of the takaful operator to underwrite and service.
- Realistic business planning for takaful operator.
- Manage the number of takaful operators in any given market.
- Provide takaful specific regulations rather than ride on existing insurance regulations.
- Do not just “cut and paste” the takaful regulations from other jurisdictions.

Conclusion

- The hybrid nature of takaful is forced onto takaful as regulations require that all insurers maintain a solvency margin. Consumer uses price as the main factor when choosing an insurer. This can lead to inappropriate pricing which cannot be sustained when no capital is available.
- Participants in a pool cannot make collective decisions. Shareholders are primarily driven by the profit motive. It is therefore important that the regulator manages the takaful market rather than expect the takaful market to manage itself.

Instead of setting up takaful businesses we should be thinking of how to start and sustain a takaful market.

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