ENHANCING SYNERGIES BETWEEN CONVENTIONAL INSURANCE AND TAKAFUL

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OVERVIEW

This paper presents a case for cooperation between conventional insurers and Islamic takaful operators. This would be of mutual benefit as they share common business goals and face the challenges of cost, capacity, and penetration. An explanation is given of the effect of Shari'a law on insurance. A description is given of existing cooperation in Malaysia, where there is a Joint Insurance and Takaful Council. Examples of the cooperation include the Malaysian Insurance Motor Pool, and a Paddy scheme for small paddy planters. Catastrophe cover is a problem, to which creative solutions are offered and tested.

บทคัดย่อ

รายงานฉบับนี้ได้นำเสนอกรณีเกี่ยวกับความร่วมมือระหว่างบริษัทประกันภัยและผู้ประกอบการ Takaful โดยจะเป็นผลประโยชน์ร่วมกันเมื่อทั้งสองฝ่ายมีส่วนร่วมในวัตถุประสงค์ของการทำธุรกิจแบบเดียวกัน และพร้อมที่จะเผชิญปัญหาเกี่ยวกับต้นทุน ความสามารถในการรองรับ และส่วนแบ่งทางการตลาด การอธิบายนี้ขึ้นอยู่กับผลกระทบของกฎหมาย Shari'a ที่เกี่ยวกับการประกันภัย การบรรยายจะเน้นเกี่ยวกับความร่วมมือในประเทศมาเลเซียที่ซึ่งมีความร่วมมือระหว่างการประกันภัยและสภา Takaful ตัวอย่างของการร่วมมือได้แก่ กองทุนการประกันรถยนต์ของประเทศมาเลเซีย และแผนการประกันนาข้าวสำหรับผู้ปลูกข้าวรายย่อย ความคุ้มครองภัยพิบัติคือปัญหาที่ต้องหาทางแก้ไขและทดสอบ

INTRODUCTION

Origins and Definition

Islamic type of insurance emerged in the second century of the Islamic era, when Arab Muslims began to venture out on long trading journeys to India and Southeast Asia and beyond. Hence they ran great risks, from natural disasters piracy, and more. Adhering to Islamic principles of mutuality and co-operation, these traders agreed to contribute to a

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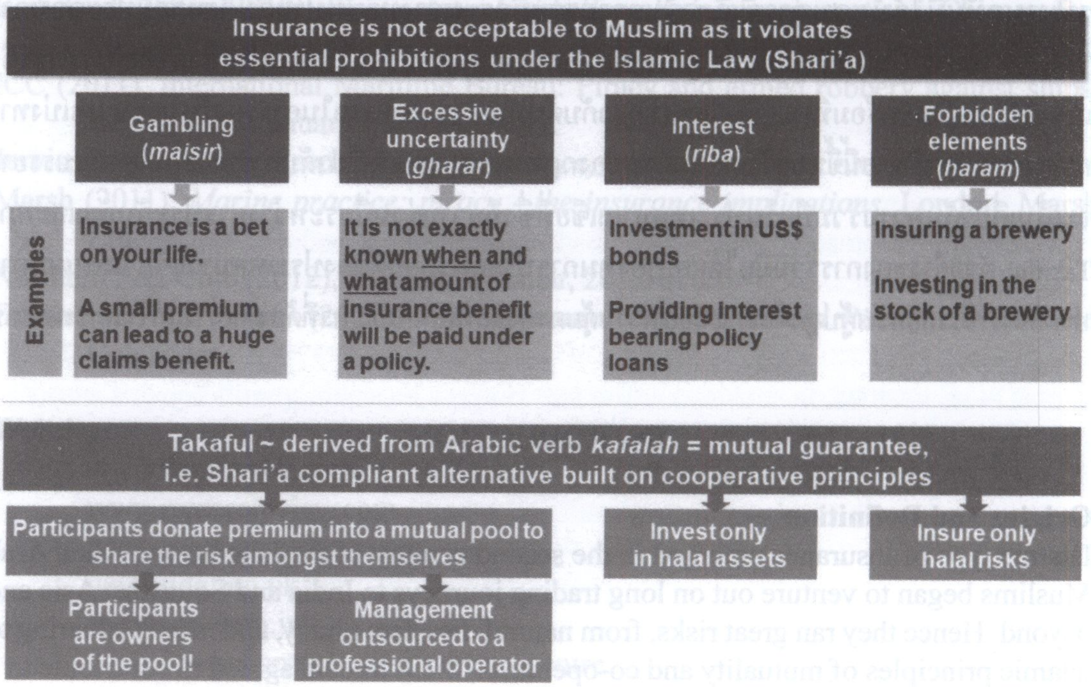
fund from which those who suffered loss would be compensated (Ali, 2008)#. The Dubai Islamic Bank and the Islamic Development Bank were established in the 1970s, along with banks in Saudi Arabia and Sudan. From the Islamic Banks emerged Islamic insurance, guided by Banks' Shariah Supervisory Boards, especially in the Faisal Islamic Bank of Sudan which founded the Islamic Insurance Company in 1979, the first ever.

In the thirty-four years since, growth of what came to be known as Takaful has been phenomenal. The Islamic Insurance Company of Malaysia was established in 1984 (Syarikat Takaful Malaysia), under the 'Takaful Act' of Parliament. In Singapore, Islamic insurance began in 1995. Indonesia, PT Assuransi Takaful Umum was established. There are many more takaful examples, including Bangladesh, Bahamas, Bahrain, Bangladesh, Brunei, Iran, Switzerland and USA. Takaful is a service to the Islamic Ummah (community) as a welfare scheme, and creates a new socio-economic mechanism based on equity, justice, and fair play. Muslims form the majority in over 40 countries, comprising more than 20% of world population, and are sizable populations elsewhere.

Traditional insurance is not acceptable to Muslims as it violates a prohibition under Islamic Law (Shariah). There are distinctions between gambling, excessive uncertainty, interest, and other forbidden elements, as in the following diagram:

Figure 1: "Insurance" in compliance with the Islamic law (Shari'a)



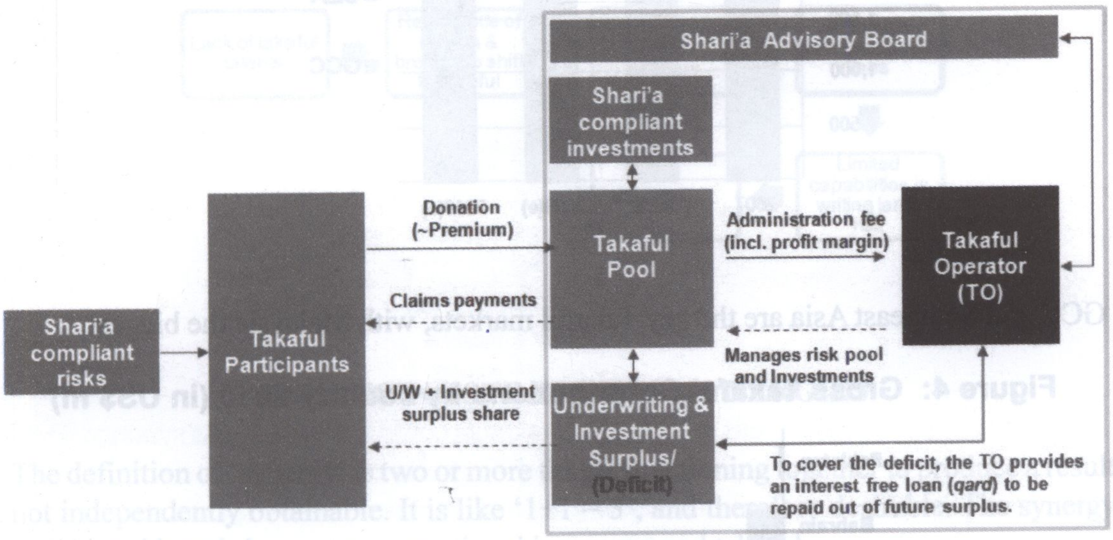
#Ali, Kazi Md. Murtuza (2008), Past, Present, and Future of Islamic Insurance, Journal of Risk Management and Insurance, Vol. 12, 1-19.

Operational Structure

Takaful is derived from an Arabic verb kafalah which means mutual guarantee, built on cooperative principles. Participants donate premiums to a mutual pool to share the risks among themselves. Participants are owners of the pool, with management outsourced to a professional operator. Muslims must invest only in halal (permisssable) assets, and must insure only halal risks.

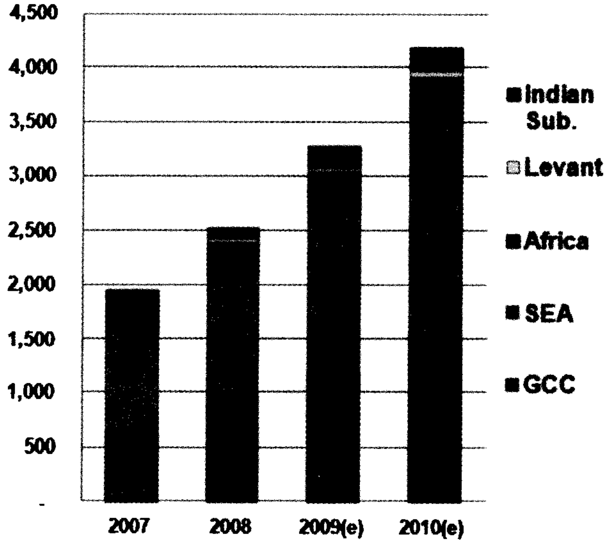
In traditional insurance, risk is transferred to an insurer. In takaful, it is shared amongst all participants. The takaful operator only administers the pool and ensures Shari'a compliance, and receives an administration fee. If there is an underwriting deficit, the operator provides an interest-free loan, to be repaid out of future underwriting surplus.

Figure 2: Operational structure a commercial takaful operation



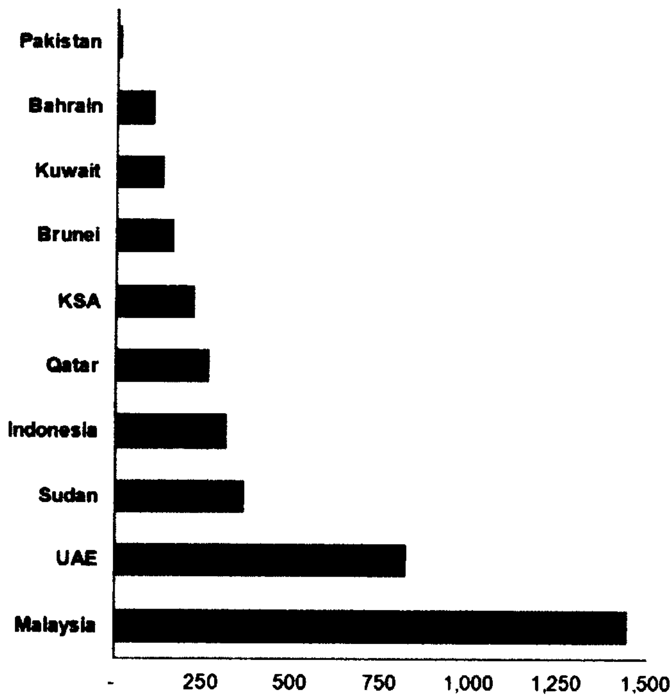
Takaful only accounts for about 1% of world premium. There are about 200 Takaful operators and 20 Retakaful organizations.

Figure 3: Global Gross Takaful Contributions (in US$ mn)



GCC and Southeast Asia are the key Takaful markets, with Malaysia the biggest.

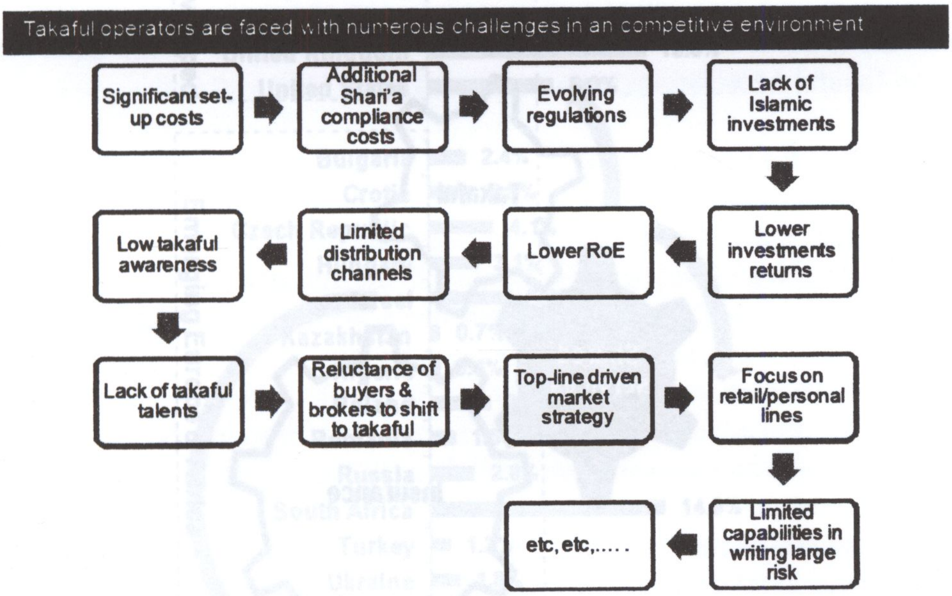
Figure 4: Gross Takaful Contributions by country 2010 (in US$ m)



Challenges to Takaful Operations

Takaful operators are faced with numerous challenges in a competitive environment. There is a sequential chain, beginning with significant set-up costs, as shown in Figure 5:

Figure 5: Takaful challenges



ENHANCING STRATEGIES: SYNERGIES

The definition of 'synergy' is two or more things functioning together to produce a result not independently obtainable. It is like '1+1 = 3', and therefore desirable. The synergy considered here is between conventional insurance and takaful.

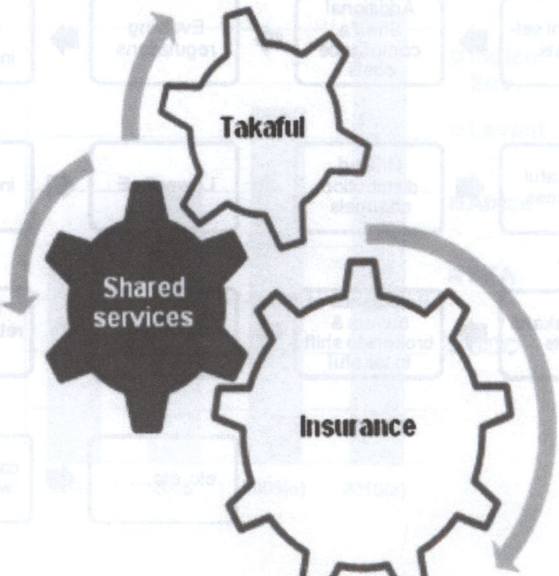
Takaful is not only for Muslim but for everyone. Meanwhile, every takaful operator is targeting Muslim customers. It is thus directly competing in an overlapping market with mature and established conventional insurers. In considering commercial insurance, the main objective of both commercial takaful and commercial insurance is to increase profits. Hence, one can only expect cooperation where there is a mutual benefit (e.g. increasing sales or reducing costs), and where the Regulator has mandated it.

Cost Synergies

The immediately obvious synergy is controlling cost through economies of scale. Malaysia is already the largest sukuk (financial certificate) issuer and takaful market. The takaful market share in Malaysia is: more than 20% of family takaful (new business), and about 10% of general takaful. The Central Bank of Malaysia has the objective of becoming the leading international Islamic financial centre in the world.

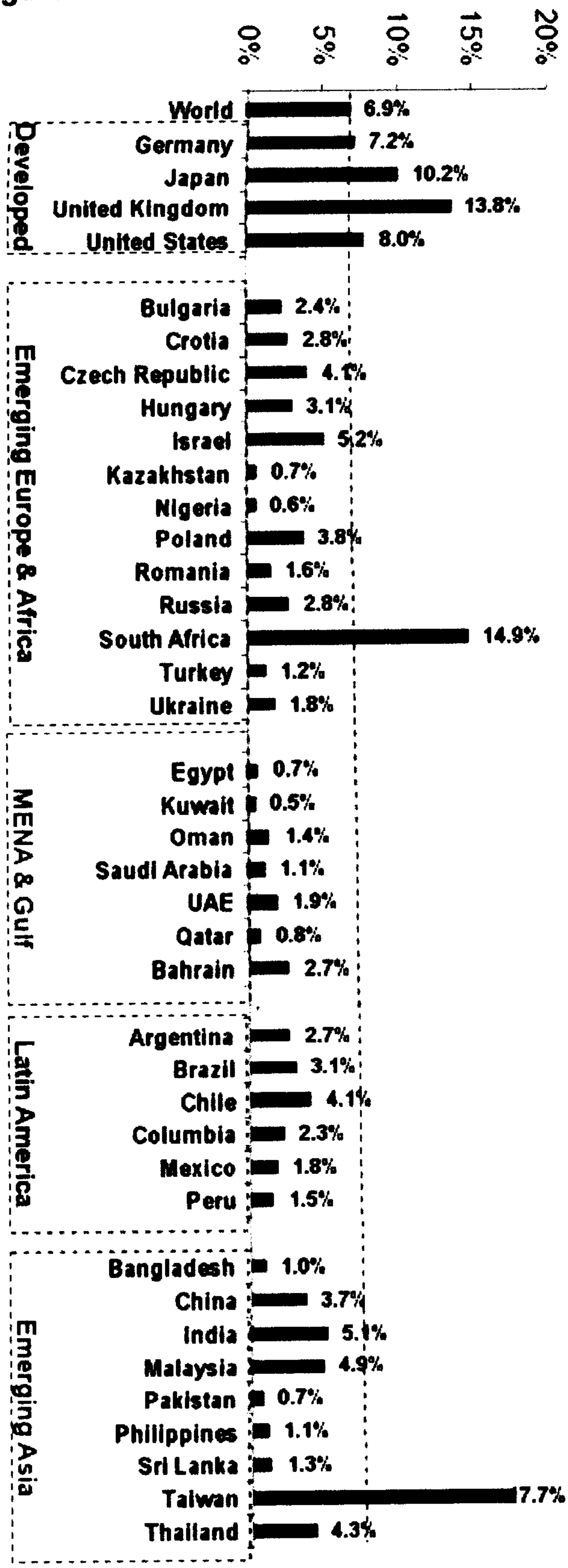
Conventional insurers can become part of that takaful sphere. Takaful can be an effective strategy for conventional insurers to maintain (and grow) market share. A group holding with both a takaful subsidiary and an insurance subsidiary can have significant synergies in a shared services model. In Malaysia, 10 out of 12 Takaful Operators are part of such a holding.

Figure 6:



Increased insurance awareness and penetration rates could befit from this synergy. There is a modest penetration rate in many Takaful markets, even in Malaysia. It is in the mutual interest of the insurance and takaful industry to increase the spread of protection and savings awareness, at the level of the individual, enterprise, and government, thereby increasing sale (and hopefully profits). Combining forces could achieve higher penetration rates as well as controlling cost. Figure 7 shows the penetration rates in 2010 for the World and 39 countries.

Figure 7: Insurance Penetration Rates 2010



There follow some examples of how synergy, combining forces, could operate.

Joint Insurance & Takaful Council
The first example is of cooperation and dialogue to achieve cooperation and synergy. In September 2011, Malaysia established a Joint Insurance and Takaful Council (JITC). It derived from an inter-association agreement between on the one hand the Life (LIAM) and non-Life (PIAM) Insurance Associations of Malaysia, and on the other hand the Malaysian Takaful Association (MTA).

The objectives of the Council are to:

* enhance harmonization between these three sectors;
* foster a high level of self-regulation in the industry;
* pave the way for a unified approach in ensuring consistency in rules, regulations, and guidance, across the three sectors;
* resolve inter-sector complaints or disputes amicably.

Some examples of Joint Council action include a standard of ethics for agents, a system for replacement of policies, control of operating costs for insurance and takaful, and preventing poaching of staff between the three sectors. There is now also a central sales agent register, a central claims database to mitigate fraudulent claims, decisions on tax incentives and their harmonization, and decisions on policy wordings.

Malaysian Motor Insurance Pool
The second example of the synergy of combined forces, is the restructuring of the Malaysian Motor Insurance Pool (MMIP). This was established in 1992 by the non-life industry, as mandated by the Regulator. It provides motor insurance to vehicle owners unable to obtain motor insurance from the normal insurance market (e.g. taxis, buses, old vehicles). It is inevitably a loss-making pool, with a loss ratio of 196% in 2011. The loss is shared equally by all non-life insurers.

In 2011 general takaful operators were asked by the Central Bank of Malaysia (BNM) which is also the insurance regulator, to join the motor pool, or to set up a separate takaful Pool. The pragmatic solution is that a new Shari'a compliant pool will be set up for both insurers and takaful operators. The old Motor Pool will cease, and be in a run-off state. This cooperation produces synergies in cost and risk sharing among the whole industry.

Paddy Scheme
The third example of cooperation is that of a paddy scheme for small paddy planters. The Central Bank of Malaysia (BNM) proposed takaful/insurance protection for 172,230 small scale planters whose individual areas of cultivation are below 40 hectares.

There are two types of cover. One is yield shortfall cover, with payment when the yield falls more than 20% (based on average yield for the last ten years). The other is multi-perils cover, for natural disasters such as storm, drought and flood, including insect or bacteria related disease. The paddy scheme is an industry pool of takaful operators and insurers. Differing from the motor pool, participation is voluntary. The scheme is government funded in the initial years, with decreasing subsidies.

CAPACITY AND REINSURANCE ISSUES

Large Risks

Takaful has been successful in penetrating person/retail line, but many general (non-life) takaful companies are lacking in technical capabilities and capacity for large risks. The fourth example, therefore examines this issue. Even if companies wanted to cede risk to takaful they might not find adequate cover, and would thus have to use conventional insurance capacity.

A solution is for a takaful operator to accept a 'follow' share in the risk, the 'lead' being a conventional non-life insurer. This would enable the enhancement of the takaful operator's (and broker's) know-how. However, this arrangement would have to be subject to a Takaful Clause, to ensure Shari'a compliance, as takaful cannot blindly follow conventional insurance terms (e.g. the risk has to be halal). This would require education and support by those cedants and brokers who lack an understanding of takaful and have shied away as they prefer to use tried-and-tested insurance capacity.

Harmonize Retakaful Practices

Reinsurance is so essential to the functioning of insurance, to provide extra financial capacity to the direct underwriters, and exert some discipline over the basics of risk/premium/terms. Retakaful practices need harmonization. There is a variety of different retakaful models, treaty wordings and halal risk screening practices. This confuses brokers and cedants. It also results in retakaful leakage, where takaful operatorts/brokers use conventional reinsurers even though a suitable retakaful alternative is available. There is thus an urgent need for harmonization to ensure smoother business processes.

To help meet this need, a Shari'a Committee of Munich Re, Swiss Re and Hannover Re met in 2010 in Dubai and agreed on general retakaful principles to facilitate global harmonization (these are in the Appendix to this paper). The agreed principles provide a basis for a revamp of 'Islamic Reinsurance' Standard No.4 by the Auditing & Accounting Association of Islamic Financial Associations. A sub-committee of the Malaysia Takaful Association was established, to develop standard retakaful contract wordings for general takaful business, and to promote their adoption at the global level through members of the Global Takaful Group.

Huge Risks

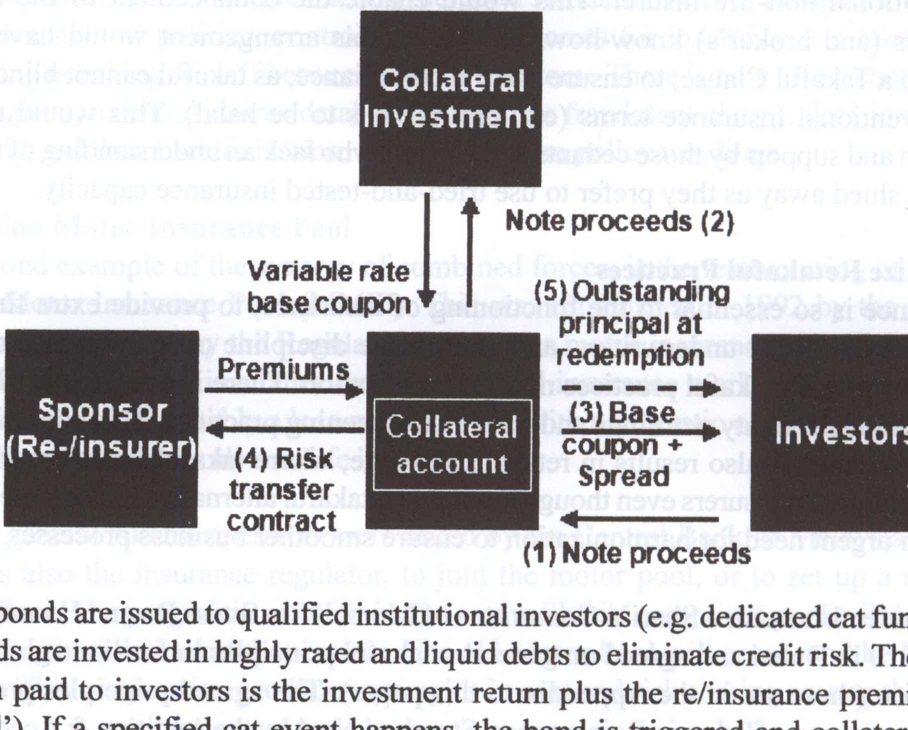
There is a steady increase in huge risks or uninsurable risks, e.g. natural catastrophes, or terrorism. It is in the mutual interest of the insurance and takaful industry to combine forces to deal with these risks. Many countries with large Muslim populations are affected by natural catastrophes, such as Pakistan, Bangladesh, Indonesia, Malaysia, and Thailand. Catastrophes affect both Muslim and non-Muslim.

To meet this mutual need, private or industry pools, or private-public partnerships could provide the organization. However, whatever is set up must be Shari'a compliant. If there is no willing insurance provider, would government step in, as last resort? Or could the capital market be brought in, as investor? There could even be Shari'a compliant Nat-Cat Bonds. Risks could be shared across all layers, from self-retention, through insurance/takaful, up to the next layer of reinsurance/retakaful, then Islamic Nat-Cat Bonds, and finally government.

An Islamic Cat Bond?

Let us compare conventional bonds and Shari'a bonds. The conventional bond structure is:

Figure 8:



These bonds are issued to qualified institutional investors (e.g. dedicated cat funds). The proceeds are invested in highly rated and liquid debts to eliminate credit risk. The regular coupon paid to investors is the investment return plus the re/insurance premium (the 'spread'). If a specified cat event happens, the bond is triggered and collateral assets liquidated to pay claims. This naturally reduces coupon and/or principal payment to investors. At maturity, any outstanding principal is returned to the investors.

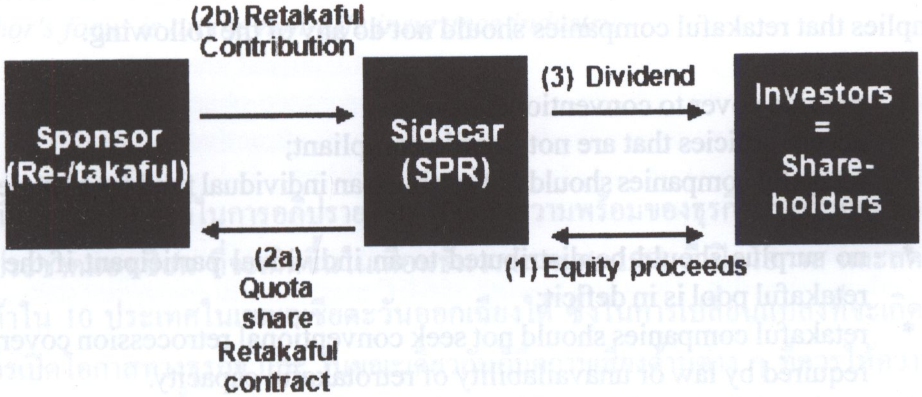
The factors in considering Shari'a bonds are many. Investors can use money from haram sources if it is then used for halal purposes. Shari'a mandates the pooling of risk of at least two takaful operators. Islamic debt can only be traded at par. In terms of law, English law prevails, but Shari'a compliance is most crucial at the structuring phase.

Concerning cat risks, only halal risks can be covered, and that is difficult to fully ensure: it requires tolerance levels, e.g. 20% haram risks are allowed. But any underwriting surplus is not a real asset or business activity. Furthermore, investments must be Shari'a compliant; risk transfer is not allowed under takaful; and the sponsor would still be liable for the underwriting deficit. Considering all these factors, an Islamic cat bond is not viable.

A Shari'a Alternative

Is there another alternative to tap capital market investors? Theoretically possible is to design a 'sidecar' to (re)takaful. It would be a limited-life special purpose entity that provides property catastrophe quota share reinsurance exclusively to its sponsor. Allow investors to take the risk and returns of a small and limited category of insurance policies written by a (re)insurer, without taking on the long-term investment risk associated with a (re)insurer's entire book of business or legacy of loss reserves. This idea is shown in the following Figure 9, but the question is whether it is economically viable.

Figure 9:



1. Investors provide initial equity investment for a Special Purpose Retakaful. Proceeds are invested in Shari'a compliant investments.
2. Risks are ceded on a quota share basis.
3. The regular dividend paid to investors is the investment return plus a share of the underwriting surplus (but this is seen as contentious by some Shari'a scholars).
4. At dissolution, any remaining capital is returned to the shareholders.

CONCLUSION

Enhancing the synergies of cooperation between conventional insurance and takaful has many mutual benefits. They share common key goals as the basis for cooperation: to increase insurance penetration; to increase profits; and to control/reduce costs.

To implement it and maintain it, continuous and formal dialogue between takaful and the insurance industry is crucial. Also, re/takaful; business must be streamlined and harmonized to allow for a smooth interface between brokers, re/insurers, re/takuful operators, and others.

APPENDIX: Basic Retakaful Principles

There are no comprehensive operational retakaful standards other than AAOIFI's Islamic Reinsurance Standard No. 41 which complements its Islamic Insurance Standard No. 26. However, these standards are rather high-level and not fully reflecting the realities of the current takaful and retakaful market.

A meeting was held by members of the Shari'a Committees of Munich Re, Swiss Re, and Hannover Re on 29 June 2010 in Dubai, to define basic retakaful principles as guidance to facilitate global harmomization. The conclusion was that retakaful contracts should follow Shari'a and takaful principles.

This implies that retakaful companies should not do any of the following:

* provide cover to conventional insurers;
* accept policies that are not Shari'a compliant;
* retakaful companies should not establish an individual fund for a single takaful operator;
* no surplus should be distributed to an individual participant if the overall retakaful pool is in deficit;
* retakaful companies should not seek conventional retrocession cover, unless required by law or unavailability of retrotakaful capacity.
* retakaful operators should not pay profit commission to an individual treaty but allocate a certain percentage of the pool surplus to the claims stabilisation reserve and for distribution amongst the pool participants (e.g. in proportion to their retakaful contributions to the total retakaful contributions or according to the proportion of their technical result to the overall technical results of the pool).
* ex gratia payments should be referred to the Shari'a committee for approval.