

A Primer on Takaful Insurance: A New Frontier for Traditional Insurance Companies?

The Principles of Takaful

Takaful is the Arabic term for “guaranteeing each other,” and takaful insurance represents the Islamic (Shariah compliant) alternative to insurance. Takaful insurance is an agreement among a group of people to jointly cover specified losses or damage that may happen to any of them out of the funds that members donate collectively. The difference between takaful and conventional insurance is that *takaful is a risk-sharing arrangement* whereas *conventional insurance employs risk transfer*. The role of the insurance company is to ensure that each participant pays equitable contribution and those who sustain a loss get properly compensated.

The principles of takaful are:

- Policyholders cooperate for the common good of all.
- Every policyholder contributes to help those that need assistance.
- Losses and liabilities are spread according to the community pooling system.
- Uncertainty is eliminated with respect to subscription and compensation.
- Takaful does not gain advantage at others’ expense.

What is not allowed in Islam is the selling or exchange of risk or transferring risk to a third party using a sales/exchange contract, not necessarily the risk or uncertainty itself. In a Takaful risk-sharing arrangement, three items must be avoided: uncertainty, gambling, and usury. This is achieved as follows:

- Participant contributions are treated as donations with a condition of compensation, not premiums as under conventional insurance.
- The pool of participants’ funds is managed and invested accordance with Shariah law. Takaful companies invest only in shariah compliant businesses and profits are distributed in accordance with pre-agreed ratios in the takaful agreement, unlike traditional insurance companies which invest in interest-based investments.
- Members share in any surplus or loss from the pool collectively.

Takaful contracts cannot be sales contracts. The following are alternative contracts that can be used:

1. **Mudharabah Contract (Profit and Loss Sharing).** This is a contract between capital providers and management, where any profit is shared according to ratio or percentage agreed by both parties. Any loss is borne entirely by the capital provider. In Takaful practice, participants provide capital to the Takaful operator.
2. **Contract of Musarakah (Joint-Venture).** Both parties provide capital and/or management. Profit is split either based on capital or upon negotiation, and any loss is distributed in proportion to capital contributions. Establishment of a mutual insurance company such as Oil Insurance Limited (OIL) can use this type of contract.
3. **Kafalah Contract (surety-ship).** A guarantor becomes the surety in the event the debtor fails to honor his obligation towards the creditor. This type of contract can be used for the development of the Takaful Scheme for Bonds products.
4. **Wakalah Contract (contract of agency).** The principal appoints and authorizes someone to act on his behalf. The authorization could be either specific or general. The agent could then charge a fee to the principal. This model is suitable for most Takaful products including products for corporate risks such as a 'Rent-A-Captive' concept.
5. **Ju'alah Contract (Contract of Commission).** Basically similar to the Wakalah contract except that the payment to the agent is measured on his output and performance. This contract could be used to develop distribution channels for Takaful.

A Growth Business

Takaful is rapidly taking hold, growing at the rate of 10-20% annually compared to the global average of 5% annual growth for conventional insurance. By 2008, the total gross written premiums (GWP) for takaful business (life and non-life combined) had grown to just under \$5.1 billion; and industry experts are projecting an \$11 billion market by 2015.

Takaful has been expanding by tapping into large Muslim markets globally. Ernst & Young's World Takaful Report 2009 noted that global Takaful contributions rose to US\$3.4 billion in 2007 from US\$2.5 billion in 2006. Saudi Arabia, with contributions totalling US\$1.7 billion in 2007, and Malaysia, with US\$797 million, are the top two Takaful markets worldwide. Yet a large, expanding, and untapped Muslim population exists on almost every continent, particularly in Asia and the MENA region. The Indian Subcontinent, Indonesia, Egypt, and Turkey, remain the least penetrated Muslim markets.

Favorable demographics, increased income earnings, higher personal consumption and changing social attitudes towards insurance are the fundamental long-term demand drivers of Takaful. A young population in core Takaful markets will need more coverage as government subsidies decrease and more families require private coverage. Regulatory support and framework, insurance legislation and compulsory coverage will facilitate its growth in the medium term.

The Opportunity for Traditional Insurance Companies

There are over 60 companies around the world offering takaful services in 23 countries. Additionally, Malaysia has developed a re-takaful business. The opportunities for expansion of takaful insurance in the GCC are positive. The considerable economic growth in the region, coupled with a sizable, underinsured population, means that there are substantial prospects for further development of personal lines coverage.

If over time the world average insurance premium of \$550 per capita is achieved and applied to the Gulf states, the GCC insurance market's potential size would be \$20 billion (currently \$4.6 billion). Using Malaysia as a proxy, where the takaful market is expected to contribute 20% to the overall market in the medium term, the GCC takaful market has the potential to reach \$4 billion at the current level of development (currently \$170 million).

How much actual business the takaful sector generates and how quickly it will do so remains to be seen, however, and will depend on the industry's ability to deliver on policyholder expectations. To be successful, the insurance industry must be able to demonstrate the need for and benefits of insurance, as well as meet customer demands.

Alliances are perhaps the easiest route to entering the takaful business. For conventional insurers, partnering with established local operators can provide existing infrastructure and access to Shari'a compliance expertise. For local Takaful operators, international insurers provide expertise in risk management and specialist lines of business.

Foreign insurers bring pockets of expertise in designing, for example, life products suited to local customers. This is gradually improving product choice, but the success of the takaful business model will depend on its ability to offer the same choice, range of products, level of coverage, cost effectiveness, and, ultimately, quality of policyholder security, as traditional insurers.

The window of opportunity over the next year or so depends on insurers capitalizing on increased alliances, cross selling, product innovation, multiplying their distribution channels, mergers and acquisitions and expansion in underpenetrated emerging markets.

To reach the retail customer, bancassurance companies provide a good distribution channel to supplement direct distribution. In the more established Malaysian takaful market, bancassurers constitute slightly more than 20% of all takaful contributions, second only to direct marketing (about 45%); but in the GCC this distribution channel remains underutilized and generally constitutes only a small amount of overall contributions generated as there are few bank-owned takaful operators.

Takaful could be the key to unlocking a largely untapped population segment. By increasing insurance awareness and delivering on customer expectations, insurers will be able to capitalize on the positive economic dynamics of the MENA region and other countries with a significant Islamic populace.

In terms of credit ratings for the takaful sector, Standard & Poor's Ratings Services will apply the same analytical process as for the traditional market, but will also take into account the sector's positive growth dynamics and high execution risk.

Sources:

The World Takaful Report 2009, Ernst & Young, April 2009

Takaful-Insurance.net, Takaful Insurance Resources for contract descriptions

“Takaful - Islamic Insurance,” Vania Gillette, Candidate Representative to the Candidate Liaison Committee