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# Investment Considerations for Takaful Islamic Insurance

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Takaful is Islamic insurance based upon mutual cooperation between members of a group, who all contribute to a pool to indemnify the members against perils and misfortunes. This article just begins to scratch the surface to introduce the main features of Takaful and to engage on common concerns within the actuarial profession.

There are two main funds in Takaful; the policy holder fund (PTF) and the shareholders' fund (STF). The policyholders are the owners of the company and the insurer only acts as an agent (Wakeel) to bring together members collectively and manage the business. The shareholders provide capital for opening the Takaful company, for handling adverse contingencies and for providing the initial seed funds till the new company achieves sufficient economies of scale and enough underwriting experience to be viable.

Accordingly, the contributions are the premiums that policyholders pay into the PTF and from which claims are subsequently paid. The Wakala fees are the management fees that the insurer charges the policyholder owners for managing the pool. Mudharab fees are the investment return that the insurer generates from the pool. Wakala fees are transferred to STF as revenue to pay for administrative and management expenses. Underwriting surplus or deficit is generated in the PTF over a period of business activity (net of wakala contributions less claims). If there is underwriting surplus, part of it is distributed to policyholders as they are the owners of the pool. If there is deficit, funds from STF called "qard-e-hasan" are transferred to pay off losses in the PTF.

This high level of transparency clearly segregates underwriting performance from investment performance and also separates the level of expenses from underwriting profitability.

There are various sub-pools within the PTF fund too as homogenous risks have to be pooled together. It would not be fair if for example, satellite coverage is combined together with motor insurance because most of the policyholders of motor will have high frequency, low severity underwriting experience instead of satellite's low frequency high severity experience. Similarly, it is not equitable to have same funds for short-term business and long-term business, and between short-tailed and long-tailed business. Obviously this does not mean that we continue building layers, like an onion, of sub pools over and over; practical considerations are also important and have to be managed along with fairness and long-term viability of the company.

Whole life and endowment coverages are usually frowned upon by Takaful, but that does not mean that they are universally deemed forbidden by all Takaful insurers. Similarly, explicit guarantees of long duration as well as underwriting that starts entering the realm of speculation are avoided. Many safeguards are also built around consequential losses to ensure that the insured does not gain from such uncertainty over future losses instead of being compensated for losses that have already occurred.

As there are different ways in interpreting the same concepts, there are different Takaful models and accounting treatments in different parts of the world. However, the spirit of mutual cooperation and ensuring prudence and fairness are the same.

Forbidding interest instruments does not mean that any fixed payments are forbidden. Trade is allowed where the trader sells the product to the customers at a profit; rent is not forbidden from property and so on. The basic concept is that "money itself does not increase money" and any value generated even in fixed quantities from the "real economy" instead of only from paper notes and money itself is allowed. The main business framework is not an impersonal unfettered free market, but fair, socially responsible and equitable trade, services and products. This ethical consideration is not new or unique to Takaful or Islamic Finance. It is as old as Aristotle, and it is seen today among many varieties of mutual societies and socially responsible investors. Religious institutions across the spectrum advocate mutual cooperation based on fairness. If anything is new or unique indeed, it is the pace with which capitalism-based insurance has influenced us in human history.

Having said that, it is not our purpose to defend or justify Takaful in relation to other forms of insurance. Our purpose here was to simply outline some core concepts to the reader who is not familiar with Takaful and then move on to investment considerations that have to be taken into account in Takaful.

## INVESTMENT CONSIDERATIONS FOR TAKAFUL

The investment policy of Islamic Insurance or Takaful Companies requires that the investments should be made on a prudent basis with a long-term perspective whilst striking a fair balance between risk and return. The policy also requires that the portfolio should be well diversified amongst various asset classes such as bank deposits, equities, Bonds, Islamic debt instruments like sukuks, real estate, etc. As per *Financial Times Lexicon*, sukuk bonds are Islamic bonds, structured in such a way as to generate returns to investors without infringing on Islamic law (that prohibits riba or interest). Sukuk represents undivided shares in the ownership of tangible assets relating to particular projects or special investment activity.

In order to determine a suitable investment strategy, available suitable assets need to be identified and the strategy developed with this in mind. The asset portfolio should, from a matching perspective, be similar.

The Takaful company has to maintain a liability driven investment strategy to map the liability duration and hold agreed strategic asset allocation derived via this process to minimize the asset-liability mismatch risk and liquidity risk.

The two distinct types of funds described earlier, PTF and STF, each have a different liability profile and therefore different objectives.

The basic objective of each Participant Takaful Fund is the pooling of risk. Risk contributions and net of wakala fees are paid into the fund and used to pay out benefits to participants resulting from various contingencies. Given that there are some funds retained within each PTF, the company invests these in order to earn a return on these funds so as to reduce the eventual cost of covering the risks the PTF is designed to cover. The investment objective of each PTF is to earn a suitable rate of return while ensuring preservation of the amount being invested.

One of the basic objectives of the shareholder's fund is to provide a buffer against any contingency in any of the PTFs. In case of any deficit in any PTF, there is a provision of Qard-Hasan (interest free loan) to be paid out from the shareholder's fund to the PTF. Therefore, it is necessary to ensure that the assets covering this risk are invested in risk-free liquid assets.

The other objective of the fund is to cover the initial costs that were incurred on building infrastructures as well as initial cost overruns (excess of actual expenses vs wakala fees receivable, the latter building up over time as business volumes grow). Therefore, a portion of the fund needs to be invested in risk-free liquid securities to cover the expenses of the company. The fund is also required to meet any minimum capital requirement applicable to the company.

The excess of capital, over the amount required to manage expenses and to cover risk of Qard-Hasan as well as any minimum capital requirement, is invested in relatively risky assets to generate high returns for the shareholders.

The asset profiles to match the requirements of each of these two distinct funds are:

| Asset Class | Fund | |
|---|---|---|
| | PTF | STF |
| **Bank call deposits** | To cover the guaranteed nature of liabilities and provide liquidity | To cover the risk of Qard-Hasan and the expense overruns |
| **Term deposits up to three months** | Same as call deposits | Same as call deposits |
| **Sukuks (matched to liability profile)** | To match the medium- and long-term liabilities | The investments will be made to match the projected operating expenses |
| **Equities & Real Estate** | The investments in this class will be made to the extent of free cash flows available | The free cash flows will be invested to provide higher return |

Some core principles relating to compliance with Islamic law Shariah are:

a. Investments made are compliant and must be compliant at all times with Islamic Shariah as advised by the Shariah Advisory Board and determined by the Investment committee.

b. Where direct investments are made, no investments are and will be made in conventional interest bearing securities.

c. Where direct investments are made in equities, as a general rule, individual companies whose activities are prohibited or are involved in sectors whose activities are prohibited ("Haram"), are not invested in. These prohibited activities are:

- alcohol and tobacco related products
- casino, hotel and gambling
- conventional banking and financial institutions
- money markets
- pork related products
- weapons related products
- leisure and illicit film industry
- conventional insurance and home financing

d. Those companies that are highly leveraged are also deleted from the remaining stocks.

e. No investments are made in conventional derivatives and no derivatives are used for speculation purposes. There are a number of Islamic derivatives in the market now—for instance, the bai salam is essentially a transaction where two parties agree to carry out the transaction of an underlying asset at a predetermined future date, but which is fully paid on the price of the present time. Other Islamic derivatives are Istisna, joala, istijrar, bai'bil wafa and bai bil istighlal contracts.

f. Investments are approved by the Islamic Shariah Consultant and have financial ratios which comply with filters that are prescribed by Islamic Shariah.

g. While the fund is not prohibited from entering into leveraging arrangements, the nature of the leveraging complies with Islamic Shariah principles and the fund may leverage up to some low specified percentage of its net asset value at any relevant time in order to take advantage of investment opportunities or meet short-term cash flow needs.

h. Investments made in mutual funds managed by third parties also have to be Shariah compliant and follow the principles set out for direct investments.

## FINAL WORDS

There is a need to involve actuaries more in Islamic insurance Takaful so that many key risks can be contained. For instance, actuaries in countries with Takaful are involved in surplus sharing, product development, investments and many more to ensure that the Shariah risk is contained and minimized and that the insurer is operationally complying with requirements of Shariah. Enterprise Risk Management should also be further propagated in Takaful institutions.

There is a worldwide movement towards impact investing and social finance where finance helps the communities instead of only maximizing profits and causing financial inequality. Takaful should seize this opportunity to increase awareness among those people who are of different religions but still value socially conscious finance. Moreover, micro insurance and technology offers us unique opportunities to increase the insurance penetration of Takaful.

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Lemonade,[1] the mobile app home insurer, is a success story in this case. Like Takaful, the surplus left from the policyholders' pool is given to charities or given back to the policyholders. Lemonade's business model is strikingly similar to Takaful because of its focus on being socially responsible. If Takaful looks the same to consumers, with the same corporate culture and organizational dynamics as conventional corporate organizations, then the unique selling point of Takaful is significantly reduced in the eyes of the customers. Lemonade is increasingly becoming popular because of technology and will continue having an edge over Takaful because it does not feel like a typical corporation (whereas Takaful does).

As noted initially, there is a wide range of practices in the Takaful field. Readers are encouraged to contact the author directly if they would like to discuss these concepts in more depth. ■

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**ENDNOTE**

1 Please go to *https://www.lemonade.com/*