SOCIETY OF ACTUARIES
REINSURANCE SECTION

REINSURANCE NEWS
SEPTEMBER 2020

A Practical Primer on Takaful From A Reinsurer's Perspective

By Tze Leong Chan

Editor's note: In this article, Tze Leong introduces the subject of Takaful (Islamic insurance) to a worldwide audience based on his experiences and observations in Malaysia and its surrounding region. Through this, he shares some reflections that we could apply to the conventional insurance market.

Understanding Takaful (Islamic insurance) is not always an easy or straightforward endeavor. Some Islamic terms and concepts underlying Takaful challenge even a seasoned insurance practitioner.

As a reinsurer, distributing knowledge to our colleagues in the industry and their practical applications is one of our roles that I am proud to play. If you were always curious about Takaful from a business perspective, you came to the right place. I spent much of my career in Malaysia and will explain Takaful as I see it and share my thoughts about what you could learn from this, even if it is not a common product in your market. While I will focus on the context of life insurance, similar considerations would apply in non-life insurance.

I am far from a scholar of this topic and this article is not aimed to be a definitive voice on this topic. Furthermore, the application of Takaful can be different across markets and practitioners as interpretation of the fundamental concepts can differ. If you are interested in delving deeper after this launching pad, feel free to let me know. There are many respected experts in the industry from whom you can seek further knowledge.

INTRODUCTORY TERMINOLOGY

Most newcomers to Takaful may feel overwhelmed by the introduction of new Islamic terminology. I will minimize using these for ease of reading. However, there are a few naming conventions that I will use throughout this article and it is therefore clearer to define them in this section for your ease:

Takaful: An Islamic term referring to Islamic insurance.

Conventional Insurance: I will use this term when referring to non-Takaful insurance products that are common across the world.

Participant: This is equivalent to "policyholder" in conventional insurance.

Contributions: This is equivalent in meaning to "office premiums" in conventional insurance.

Takaful Operator: In this article, this is used to refer to the organizational structure of an "insurance company" in conventional insurance.

Tabarru': An Islamic term meaning "donation." The purpose of the Tabarru' is to provide assistance to fellow participants. It is, subject to some caveats, equivalent in meaning to "risk premium" in conventional insurance.

Family Takaful: While not specifically used in this article, this is a term that is used as a substitute for "life insurance" in Takaful, and which comprises policies that cover risks associated with human life, e.g., death, disability and illness.

THE ROLE OF TAKAFUL

The need for Takaful in the modern world arises from three main principles within the Sharia (Islamic law) which are incompatible with conventional insurance[1]:

1. **Prohibition of Gambling (maysir):** Conventional insurance introduces an element of gambling as the policyholder pays a relatively small premium in exchange for a large payout if the insured event occurs.

2. **Prohibition of Excessive Uncertainty (gharar):** Is a broad concept that refers to the lack of transparency or certainty in a conventional insurance contract on the returns to the policyholder.

3. **Prohibition of Interest (riba):** Fixed or guaranteed interest is forbidden. This means that conventional insurance products that offer an interest guarantee (such as an endowment) would be forbidden. In addition, this principle also applies to the assets backing the conventional insurance fund, many of which (such as bonds) will violate this principle.

Strict compliance to these principles means that Muslims would be excluded from the financial protection offered by the conventional insurance market. Takaful therefore emerged as a solution to this. It is further supported by the development of Islamic finance and Sharia-compliant financial instruments, which both provided access to suitable assets and awareness to the Muslim community.

The fundamental distinction of Takaful is the basis of "risk sharing" as opposed to "risk transfer" (of biometric and interest risks) which is practiced in stockholding insurance companies. Whereas we have seen a trend of de-mutualization in many countries, the Takaful concept basically reverts back to the mutual concept under consideration of the above mentioned three Islamic principles.

THE TAKAFUL BUSINESS MODEL

There are several methods to structure a Takaful business model based on the Sharia-compliant principles. These are readily available in various publications (along with flow diagrams). I shall not delve into each of these in this section but will provide the highlights and their contrast compared to conventional insurance.

The usage of the term "Takaful operator" as the provider of retail Takaful products hints at the business model. Imagine a community of individuals who wish to form a fund that pools their respective risks against their death. Each **participant** can make a **tabarru**' into the fund based on their respective risk and desired insurance benefit amount. For efficiency and objectivity, they may then appoint an agent to administer and manage the fund, namely the Takaful operator. In exchange for this service, the Takaful operator would be given an administration fee, which each participant pays in addition to their tabarru'. In the spirit of risk sharing, surplus from the fund (tabarru' less claims) would be distributed to the participants based on a pre-determined formula. In certain arrangements, the surplus could also be shared with the Takaful operator either as payment for the administration service or as an incentive to properly manage the fund.

In a modern context, the reality is somewhat the reverse of this scenario: shareholders set up a Takaful operator. The Takaful operator subsequently sets up a risk pool and designs Takaful products, including the **contributions** to be paid by interested participants. This is analogous to how a conventional insurance company develops, distributes and manages its products. The management of the surplus sharing mechanism is akin to a conventional participating insurance product in a mutual company—the determination of surplus and its allocation between the participants and Takaful operator follow analogous principles.

A further unique role played by the Takaful operator arises in the scenario that the risk pool enters a deficit. One common approach is that the Takaful operator will make an interest-free loan ("qard") to the risk pool that is only recoverable from future surpluses if they emerge. This results in a potential financial risk for the Takaful operator, which needs to be accounted in its financial risk and capital management.

Takaful in modern times are a hybrid of concepts familiar to practitioners of conventional insurance, such as mutual and participating insurance.

APPROACHES TO CORPORATE STRUCTURE

Corporate structures are generally dependent on the prevailing laws and regulations in the market that the Takaful operators are licensed in. This may vary between countries like Malaysia, Indonesia and those in the Middle East.

In Malaysia, Takaful operators are legally licensed to market only Takaful insurance. It is therefore not uncommon to see multinational insurance companies with separate entities for a conventional insurance company and Takaful operator in the market.

In contrast, insurers in Indonesia are allowed to operate on a "window" approach until 2024[2] when separation of licenses will be required. The window approach means that a single entity markets and manages both conventional insurance and Takaful products. The management of Takaful business may be run by a dedicated sub-division within the entity.

While we will not discuss these in detail, both the above structures would elicit different approaches and implications on each of the following items, especially for a multinational insurer operating in both markets:

1. Ownership and governance (a Takaful operator typically requires a Sharia council of Islamic scholars to ensure that its activities are Sharia-compliant).
2. Capital requirements.
3. Backing assets.
4. Separation of funds or pools.
5. Human resource requirements.
6. Compliance (or perceived compliance) with Sharia principles.

RETAKAFUL OPERATIONS

The Retakaful market is arguably less developed or regulated compared to the primary Retakaful market. Retakaful operators use approaches that largely mirror that of conventional reinsurance while adopting similar practices to those described above for Takaful operators.

The practice of surplus sharing in Retakaful is also analogous to a practice that is already familiar to reinsurance companies—offering profit commission. There is one interesting distinction in this practice as compared to both a conventional reinsurer and a Takaful operator. A Takaful operator's risk pool consists solely of its own participants who are the end consumers of Takaful products. In contrast, the participants of a Retakaful operator's risk pool are technically its Takaful operator clients. This means that each Takaful operator clients' receipt of surplus is dependent on the experience of other Takaful operator clients' portfolios within the same risk pool.

In terms of corporate structure, Retakaful operators are faced with the same business and legal considerations. Some global reinsurers have set up dedicated local Retakaful entities that solely write Retakaful business, while others operate on a window approach. In South East Asia, Retakaful business can be written through a window set up in Labuan (an offshore financial center of Malaysia) while actual operations are carried out by a division in the reinsurance company. In 2019, the total Retakaful contributions written through Labuan was USD100.6 million, which is almost double the volume written in 2015 of USD55.3 million.[3]

MARKET ANALYSIS AND LESSONS

Takaful operations in South East Asia are mainly found in Indonesia and Malaysia:

- Indonesia has the world's largest population of Muslims, with close to 230 million Muslims which is almost 90 percent of their population.[4] Despite this, conventional insurance premium is still the dominant insurance solution. According to estimates, Takaful contributions are less than 10 percent of the total life insurance premiums.[5]

> The need for Takaful in the modern world arises from three main principles within the Sharia (Islamic law) which are incompatible with conventional insurance.

- Malaysia has a population of about 32 million and more than 50 percent are Muslim. Takaful contributions have emerged as a significant portion of the insurance sector, making up approximately 30 percent of new business premiums in 2019.[6]

There are a myriad of explanations and observations that could explain why Takaful has not seen wider popularity as a solution for the Muslim community and that could provide lessons to anyone looking to expand into new market segments.

Necessity and Preferences

Assuming all features and financial requirements are equal, a Takaful product would be costlier than an equivalent conventional insurance product. The surplus sharing and qard elements introduce additional risk to the Takaful operator that needs to be priced.

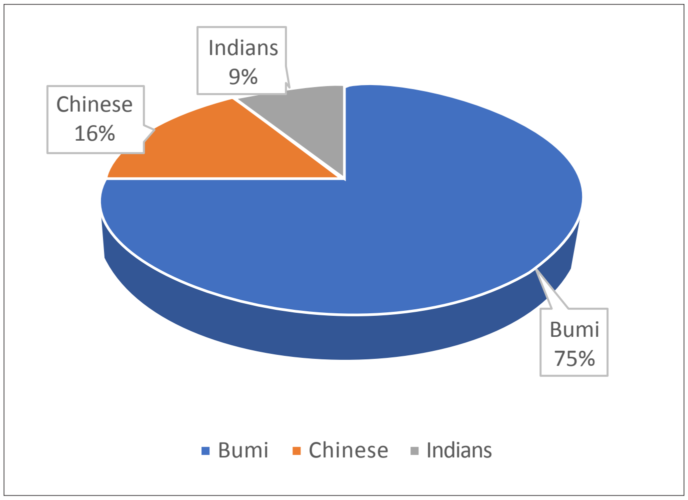
It appears that the Muslim community in these countries are not necessarily opposed to being policyholders of conventional insurance. A contributing factor could be the access to Takaful products, whether for benefits or at a price that is appropriate, which may not be available.

It is interesting to note that Takaful products are not exclusive to the Muslim community—in fact, non-Muslims do find some attraction in Takaful products and they are not forbidden from taking up these products. The surplus sharing concept offers an upside that could be attractive as this mitigates overpayment of risk premium if the overall claims experience improves.

Socioeconomic Situation, Distribution and Access

Both Malaysia and Indonesia are countries with disparate wealth inequality across the population and geographic regions. In Malaysia, at least, Muslims are disproportionately represented in the lower end of the income. Figure 1[7] shows that 75 percent of the bottom 50 percent of the income segment are of the Bumi ethnic group, which is predominantly Muslim.

Figure 1
Population Share in 2014 of Ethnic Groups in Bottom 50 Percent (Pre-tax National Income)



In the lower income segment, access to insurance solutions is more limited:

- The lower income community disproportionately reside in rural areas (geographically harder to access), therefore access to products that are traditionally sold by agents or banks is restricted.
- The inability to afford insurance premiums mean that they are less attractive prospects for products where distributor remuneration is based on premium size.

The introduction of Takaful solutions does hence not necessarily fulfill the needs of the lower income Muslim population, unless they are tailored in the same style of microinsurance. This could explain the disparity between the representation of Muslims in the population and the proportion of the Takaful in the insurance industry.

Modern technology will certainly help in this aspect, for example, microtakaful schemes that can be distributed through mobile phones. It remains to be seen whether these are commercially viable to Takaful operators to successfully launch.

In Malaysia, the mySalam scheme[8] was launched in 2019 as a free national health protection scheme for those at the bottom 40 percent of the income distribution. This scheme was designed as a Takaful for a number of reasons: it gained acceptance from the Muslim community, ensured a higher penetration rate, and allowed a generous profit-sharing scheme. The mySalam scheme can be seen as a hybrid of a microtakaful scheme and social security protection.

CONCLUSION

I hope that this provides a basic overview of what Takaful means and its role in the insurance industry. It is certainly a relevant case study for any entrepreneur who is interested in entering into a new market segment. ■

Tze Leong Chan heads the Strategy and Business Development function for Gen Re Life/Health's Indonesia market. He can be contacted at *Tzeleong.chan@genre.com.*

ENDNOTES

1 Gönülal, Serap O., ed. 2012. *Takaful and mutual insurance: alternative approaches to managing risks.* The World Bank.

2 Ferguson, Nick. 2019. "Fixing Indonesia's takaful sector." *Insurance Asia News. https://insuranceasianews.com/fixing-indonesias-takaful-sector/*

3 Labuan International Business and Financial Centre. 2019. *Market Report 2019. https://www.labuanibfc.com/clients/Labuan_IBFC_78C2FF81-703A-4CAA-8926-A348A3C91057/contentms/img/resource_centre/publication/download/2020/Market%20Report%202019_FinalV_27052020. pdf?1595823216*

4 *https://worldpopulationreview.com/countries/muslim-population-by-country/*, Accessed May 31, 2020

5 Own calculations from: *https://www.idnfinancials.com/news/30715/life-insurance-industry-performance-grows-q* and *https://www.meinsurancereview.com/News/View-NewsLetter-Article/id/49729/type/MiddleEast/Indonesia-Shariah-insurance-body-upbeat-about-takaful-market*

6 Statistics acquired from Bank Negara Malaysia (BNM) website on May 31, 2020: *www.bnm.gov.my.*

7 Abdul Khalid, Muhammed and Li Yang. 2019. "Income inequality among different ethnic groups: the case of Malaysia." *LSE Business Review.* London School of Economics and Political Science. *https://blogs.lse.ac.uk/businessreview/2019/09/11/income-inequality-among-different-ethnic-groups-the-case-of-malaysia/*

8 *https://www.mysalam.com.my/b40/info/?url=intro_EN*