Swiss Re

Islamic Insurance revisited

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Executive summary

This publication builds on the *sigma* No 5/2008.

This publication is an update of the "Islamic Insurance" section of the *sigma* No 5/2008, which considered how companies involved in takaful could best serve the Muslim population throughout the world. This current publication builds on the *sigma* No 5/2008 by filling in the key issues, changes, and developments from 2008 until today.

Islamic insurance has different forms, of which takaful is the most broadly accepted.

Of all the different models of Islamic insurance, takaful is the one most accepted by shariah scholars. Takaful is based on mutual assistance, joint risk-taking by the policyholders, and a clear segregation of policyholder funds and shareholder (operator) funds. Takaful companies adhere to a shariah-compliant investment strategy and are supervised by an independent board of shariah scholars.

Takaful contributions in Muslim countries, estimated at USD 3.4bn in 2010, continue to grow strongly.

Despite the global financial crisis and slow-down in growth in the conventional insurance sector, takaful continued to achieve an average annual growth rate of nearly 30% (inflation adjusted) between 2007 and 2010. In 2010, total takaful contributions amounted to USD 3.4bn, or 4.4% of total insurance premiums and takaful contributions in Muslim countries. Malaysia is the largest and most advanced market, followed by Saudi Arabia, the United Arab Emirates and Indonesia.

Malaysia and Bahrain are the leaders in setting takaful-specific regulation.

Malaysia's and Bahrain's takaful regulations are perceived as the most advanced. Malaysia has certain measures in place, such as tax incentives, that favour takaful while Bahrain fosters takaful growth through harmonisation and standardisation. In the UAE, specific regulation has only been introduced recently.

Takaful business models have been gradually converging, but more standardisation is still needed.

Takaful industry practise is gradually converging towards hybrid business models, which combine a fixed fee model for underwriting (wakalah) with profit-sharing for investment activities (mudarabah). Against this wave of standardisation, however, lie persisting barriers to convergence. These barriers not only add to consumer confusion but also hinder industry growth.

Strong economic conditions should support continuing growth over the next few years …

Strong economic and population growth is likely to support the growth of the takaful industry over the next few years. Add this growth to the low penetration of takaful in the market and total contributions could double by 2015, although still from a low base. However, the takaful industry will remain concentrated in only certain key markets in the Middle East as well as Southeast Asia.

… but for sustainable growth, key challenges will need to be addressed: consumer awareness, industry standardisation, and financial market readiness.

Sustained growth over the longer term and an extension of takaful beyond the Muslim countries will require key issues to be addressed. First, consumer awareness and product development is important even in the most advanced markets, not only for takaful but also for the concept of insurance in general. Second, for a truly global takaful sector to develop, the industry needs a higher degree of standardization in terms of business models and regulation, particularly in developed countries with multicultural Muslim populations or even with non-Muslims. Finally, the success of takaful depends on developed and deep Islamic financial markets with a broad range of investment opportunities. A large primary market with Islamic bonds (sukuk) but also a liquid secondary market is important for takaful companies to efficiently match assets to liabilities and earn attractive investment returns for policyholders.

Strict observance of shariah principles is of utmost importance, or else consumers may question the integrity of the industry.

To uphold the integrity of the industry, strict observance of shariah principles is required in every aspect of takaful operations. Otherwise, consumers might perceive takaful as being the same as conventional insurance. One example of best-practice abidance to shariah law is consistent use of retakaful instead of conventional reinsurance, especially given the present availability of highly rated capacity for the industry.

Introduction

Takaful is the most accepted model of Islamic insurance, and is based on mutual assistance and voluntary contribution.

Often Islamic insurance and takaful are used as synonyms, however it is important to distinguish between the two. In this report, takaful refers to the group of Islamic insurance models that are most broadly accepted by shariah scholars. Takaful is a system based on the principles of mutual assistance (ta'awun) and voluntary contribution (tabarru), where risk is shared collectively.

This publication provides an update to the section on Islamic insurance in the *sigma* No 5/2008.

Since 2008, when the *sigma*[1] on Islamic insurance was published, the takaful industry has altered rapidly. The company landscape, market size, regulatory environment, takaful business models and the availability of retakaful capacity have all undergone great change. Moreover, data is more readily available and transparency has improved, providing more than enough reason to revisit the main findings of the *sigma* No 5/2008 and update the takaful market estimates and future growth expectations.

Among Muslims, who represent 25% of the world's population, insurance penetration is low because it clashes with shariah.

The fundamental data from the 2008 *sigma* remains unchanged: Muslims account for a quarter of the world's population and they continue to have limited access to the benefits of insurance. One reason for the low insurance penetration among Muslim populations is that shariah (the body of Islamic law) forbids conventional insurance and people are often not aware that a sharlah-compliant alternative exists in the form of takaful.

Takaful is a permissible form of insurance under Islamic law for which there is great untapped potential.

Virtually all Islamic scholars agree that some forms of insurance are permissible provided that certain conditions are fulfilled (eg investments are in shariah-compliant assets). There is a huge potential market for takaful, the most widely accepted form of shariah-compliant insurance. The takaful market has grown close to 30% annually since 2008, yet the industry remains small and insurance penetration in Muslim countries[2] is still low.

The focus of this report is on the key Muslim countries.

The challenges of the rapidly growing industry are being gradually addressed, but plenty of areas of work remain. Despite the roughly 20 million Muslims that live in developed countries, attempts to introduce takaful there have met limited success. Takaful remains concentrated in the key markets of Malaysia, Indonesia, Saudi Arabia, the UAE and Bahrain. The focus of this report is on the Muslim emerging market countries.

Data on takaful is scarce, so a fair amount of assumptions are made in this study.

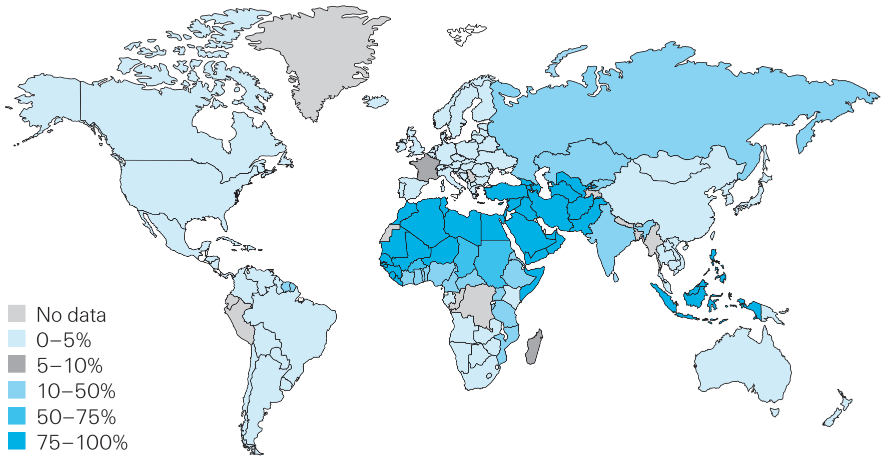
Data on takaful from supervisory authorities remains very limited except in the case of Malaysia and Bahrain. Therefore, the *sigma* and this update are based on a number of estimates. These estimates have been revised as new or more accurate data has become available since the publication of the *sigma* in 2008.

[1] Swiss Re *sigma* No 5/2008, "Insurance in the emerging markets: overview and prospects for Islamic insurance"
[2] Muslim countries are those with a Muslim population of 50% or more.

The structure of this report

In the first part of this update, the main Islamic insurance business models are summarized and the corresponding market sizes shown. Then, an overview of the regulatory developments in key takaful markets is given, followed by an overview of market size and performance. The report concludes with the opportunities and challenges as well as an outlook for the sector.

Figure 1;
Share of Muslim population



Sources: US State Department, CIA world fact book, Swiss Re Economic Research & Consulting

Islamic Insurance models

Overview

According to most Islamic jurists, conventional insurance is not aligned with shariah.

According to most Islamic jurists, conventional insurance is not aligned to shariah, the body of Islamic law, since it may involve fixed interest (riba), excessive risk taking (maisir), uncertainty and unclear terms (gharar), and investment in unacceptable (haram) industries such as breweries or gambling. Since interpretation of the shariah principles differs substantially across countries and regions, various Islamic insurance models have developed.[3]

The following main Islamic insurance models are currently in practise:
- The takaful models with segregated funds
- The non-profit model, as mainly practised in Sudan
- The cooperative model of the Saudi Arabian regulator (SAMA)
- The Iranian Insurance model

In this report, as well as in the previously published *sigma*, a distinction is made between Islamic insurance and takaful. While Islamic insurance refers to all concepts of Islamic insurance, takaful refers only to the models that segregate the funds of policyholders from the funds of the shareholders of the operating company.

Takaful business models

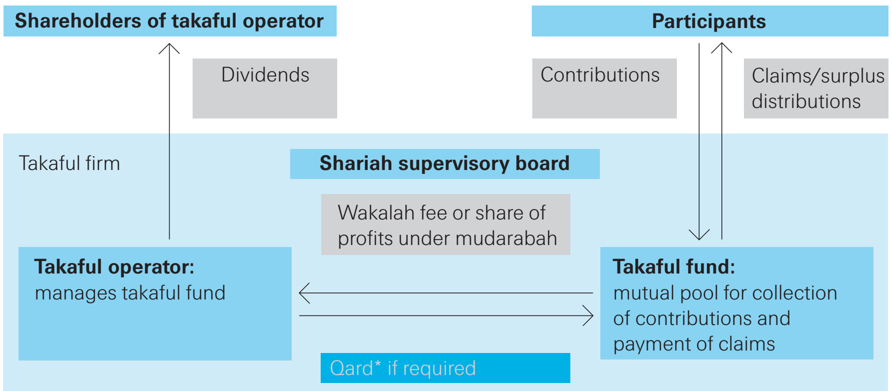
Takaful is based on the principle of mutual assistance.

Takaful is based on the principle of mutual assistance (ta'awun) and voluntary contribution (tabarru), where the risk is shared collectively and voluntarily by a group of participants. Through payment of a voluntary donation and a clear definition of the type of loss, uncertainty (gharar) and excessive risk taking (maisir) are removed from the takaful contract. In some of its forms, takaful has been practised for centuries as a system of mutual risk sharing.

Segregation of funds, shariah-compliant investments, and an independent supervisory board of shariah scholars are the main features of takaful.

Takaful has three key features: it separates policyholder funds from shareholder funds, it adheres to a shariah-compliant investment strategy by avoiding the payment of interest and by refusing to do business with firms engaged in forbidden activities, and it requires an independent internal supervision board of shariah scholars. In the three prevailing takaful models, the operator receives a pre-agreed fee (the wakalah and wakalah-waqf models), a share of the underwriting surplus (the mudarabah model), or a combination of both (the hybrid model) in exchange for managing the fund on behalf of the policy holders.

Figure 2:
Simplified structure of the generic takaful model



Sources: Fitch, Economic Research & Consulting
* (Voluntary) interest free loan

[3] More background on the different interpretations and opinions can be found in "Swiss Re, *sigma* No 5/2008, p. 19-21.

Takaful products are sold by dedicated Islamic firms or through the Islamic window of a financial institution.

Takaful products are usually sold by companies set up as fully Islamic firms, where the entire business operations are undertaken in accordance with shariah. In some cases, regulators allow takaful products to be sold by conventional financial institutions through an Islamic window. Takaful products may be purchased by both Muslims and non-Muslims. Usually, life insurance is called family takaful and non-life insurance is called general takaful.

Retakaful funds can only accept contributions from takaful companies.

Reinsurance along the takaful model is called retakaful. It is structured similarly to takaful except that the participants are primary takaful companies. While takaful is acceptable for non-Muslims, retakaful funds may only accept contributions ceded by takaful companies.

Although implementation varies by company and depends on the regulatory environment, the shariah supervisory board and the management, takaful can nevertheless be categorised into a few overarching models. The main types of takaful models are explained below.

Wakalah model

Under the wakalah model, the operator receives a fixed proportional share of the contributions.

Under the wakalah model, takaful companies act as pure operating agents for the participants – i.e. policyholders. The wakalah model is similar to a mutual fund in that the operating agent receives a pre-agreed fee – usually a fixed proportion of the contributions paid by the policyholders – to invest the takaful funds and run the takaful operation on their behalf. The operating agent does not receive any of the underwriting surplus and investment profits or incur any underwriting and investment losses. If, however, the takaful fund runs a deficit, the operating agent has to provide an interest-free loan (qard) to the takaful fund, to be repaid when the fund has a surplus.

In the wakalah model, there is an incentive for the operator to maximise fee income from contributions.

Under this model, the operating company can only make a profit if its operating expenses are below the fee income. The operator does not formally carry underwriting risk, so could be tempted to maximize contributions without properly assessing the risks. Some variants of this model use an incentive fee for the operator to promote adequate risk assessment in underwriting to address this concern. Likewise, obliging the operator to provide an interest-free loan in case of deficit provides an incentive for disciplined risk assessment.

Mudarabah model

Under the mudarabah model, the operator receives a share of the surplus.

The mudarabah model is essentially a profit-sharing model. In contrast to the wakalah model, the operating agent receives a pre-agreed proportion of the surplus generated by the policyholders' fund and the profits earned on investment activities. As under the wakalah model, the operating agent must provide an interest-free loan to the policyholders' fund if a deficit occurs.

Under this model, the operator can only make a profit if operating expenses are lower than the operators share in underwriting surplus and investment income combined. Efficient fund management and proper risk assessment are thus in the operator's best interest. On the other hand, volatile income from underwriting and investments can be a challenge, particularly during the start-up phase of a policyholders' fund.

Hybrid model

The hybrid model combines elements of the mudarabah and wakalah models.

The hybrid model is a combination of the wakalah and mudarabah models. The operating agent receives a pre-agreed share of the contributions paid by policyholders plus a share of the profits earned on investment activities. Some financial regulators and international organisations (e.g. the Accounting and Auditing Organisation for Islamic Financial Institutions, or AAOIFI) recommend the hybrid model because it leverages the strengths of both the wakalah and mudarabah models. Applying the mudarabah model to investment activities helps mitigate principle-agent problems, whereas the use of the wakalah model allows the operator to recover the administrative costs of underwriting.

Under the wakalah-waqf model, the operator makes an initial donation to the takaful fund.

Wakalah-waqf model
Under the wakalah-waqf model, the operating agent sets up the cash part of the waqf (an Islamic trust or endowment) by providing an initial donation. The Policyholders make contributions to the tabarru part of the waqf fund, which is then used to settle claims. The operating agent earns a fixed underwriting fee (wakalah fee). Policyholders may receive a share of the surplus in the pool after all claims are paid. The surplus can also be used to set up reserves and to make donations. It may also be modified to allow for profit sharing on the side of investment activities. As in the wakalah model the operating agent provides a qard in case of a deficit in the fund.

The incentives for the operator in this model are very similar to the wakalah models, but the waqf model addresses a key shariah issue about the ownership of participants' contributions in the wakalah model.

Under the non-profit takaful model, participants become owners and operators by donating to a fund.

Non-profit takaful model
Under this model, mostly used in Sudan, the start-up capital for a fund comes in the form of an interest-free loan. By donating to the fund, participants become owners and operators of the fund.

Most takaful operations today are stock companies.

Summary and adoption of takaful models
On the surface, takaful resembles a conventional mutual insurer concept. Upon closer inspection, however, the vast majority of takaful companies today operate like stock companies. Unlike traditional mutual companies, takaful companies are hybrid companies that are profit-oriented and capitalised like any other ordinary stock company. The element of mutuality is restricted to the takaful fund, where the policyholder contributions (i.e. premiums) and investment income are collected. By providing an interest-free loan to the takaful pool in the event of an underwriting deficit, however, takaful companies use capital to cover their liabilities just as a stock company would.

At the company-level, the implementation of models varies greatly due to different interpretations by shariah supervisory boards.

On a company level, standard takaful models are adapted to local needs using features such as incentive fees. Even within the same takaful company, several models may be used depending on the product. Many companies tend toward wakalah or hybrid models. The wakalah-waqf model has also gained increasing acceptance and regulatory approval in Malaysia and Indonesia, as it addresses several shariah issues present in the other models. In contrast, the pure mudarabah model for underwriting and investment is no longer practised for new family products and seldom for general products. Many scholars, particularly in the Middle East, deem this last model unacceptable as the operator shares in the profit, but not in the deficit of the fund.[4]

Other Islamic insurance models

The Saudi cooperative model is prescribed by the Saudi regulator.

The Saudi cooperative model is prescribed by the Saudi Arabian Monetary Agency (SAMA), the Saudi regulator, and is shariah compliant through Saudi religious law. The model is defined in the insurance regulation and does not prescribe any of the takaful models. Under the cooperative model, companies have to:
- be established as a joint stock company
- return at least a 10% surplus from insurance operations to insured persons, after all legal reserving requirements have been met
- invest at least 20% of policyholder funds in government bonds and 20% in bonds issued by Saudi-authorised banks

Iranian insurers operate on a conventional basis within the Islamic financial system.

Under the Iranian Islamic insurance model companies operate in a conventional way within the Islamic financial system.

[4] Milliman (2011), "Global Family Takaful Report 2011" offers an in-depth view on adoption of the models and concrete examples of models for family saving and unit-linked products.

Summary on Islamic insurance models

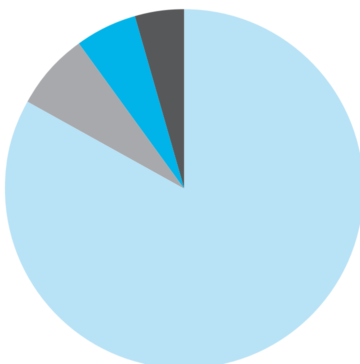
Although takaful and Islamic insurance are often thought as synonyms, the distinction between takaful models with segregated funds and other Islamic insurance models is important for several reasons:

- The takaful models have gained broad acceptance in the industry and in some form have also been adopted by international bodies like the Islamic Financial Services Board (IFSB) or the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).
- Lumping together all very different types of Islamic insurance models under the takaful term only promotes consumer confusion and hinders takaful's success.
- From a retakaful perspective, it is questionable if cessions from companies running other Islamic insurance models (eg the Saudi Arabian cooperative model or the Iranian model) are acceptable in the retakaful fund.

Conventional models are dominating the insurance markets for Muslim countries.

In Muslim countries, conventional insurance is still predominant, as can be seen in the share of total contributions and premiums in figure 3. In 2010, overall premiums and contributions written in Muslim countries amounted to USD 73bn (2007: USD 54.6bn). Of these premiums, 83% (USD 60.6bn) was generated on a conventional basis. Islamic insurance models had a share of 17%, including 4.4% from takaful, 7.0% from Iranian model and 5.4% from the Saudi cooperative model.

Figure 3:
Muslim countries' insurance models in 2010 (in USDm; % of contributions/ premiums written)



Conventional Insurance	60572	83.1%
Iranian islamic insurance model	5087	7.0%
Saudi Arabian cooperative model	3968	5.4%
Takaful	3230	4.4%

Sources: Economic Research & Consulting, supervisory authorities, company annual reports, World Islamic Insurance Directory

Regulatory developments

Country developments

The main features of the regulatory frameworks Malaysia, Indonesia, Bahrain, the UAE and Saudi Arabia were outlined in the *sigma*. Among these focus markets, Malaysia and Bahrain were perceived as being the leaders for setting transparent and specific rules for takaful companies. Since 2008, regulation has also evolved in other markets, but Malaysia and Bahrain are still at the forefront. In Turkey, secular legislation prohibits the use of Arabic terms in financial services in general, but not the takaful concept itself.

Malaysia

Malaysia remains at the forefront of global regulation for takaful.

Malaysia, in its aim to become a global hub for Islamic finance, remains a pacesetter of takaful regulatory developments. Its central bank, Bank Negara Malaysia (BNM), is the regulatory authority and actively fosters takaful growth. For example, the new "Takaful Operational Framework", comes into effect in January 2012. Its objective is to enhance takaful business efficiency, ensure healthy and sustainable takaful funds, safeguard participant interests, and promote uniform takaful business practices.[5] Additionally, the BNM proposed an adapted version of the risk-based capital framework (RBC), which applies to conventional insurers since January 2009. A draft of the RBC framework for takaful has recently been published for further consultation and is due to become effective within the next three years.

Indonesia

Indonesia has strengthened its takaful framework.

The Indonesian regulator has set lower capital requirements for takaful companies than for conventional ones supporting the takaful business. It currently allows both full-fledged takaful companies and window based operations, but companies can only offer either family or general takaful products. The regulator has strengthened the takaful operating framework via a measure introduced in 2010 requiring that companies establish a shariah control board and strictly separate shareholder and policyholder funds. Also, the minimal capital level for takaful companies will likely increase going forward and there are plans to forbid window operations in order to encourage the establishment of pure takaful operations.

Bahrain

Bahrain continues to lead takaful regulation in the Middle East.

Bahrain was the first country in the Middle East to introduce takaful-specific regulation in 2006. Its unique takaful framework is still considered the most advanced in the Middle East. The framework takes a neutral approach to takaful, providing a level playing field between conventional and takaful companies. By setting mandatory standards for takaful companies, the regulator stipulates the use of the hybrid model for takaful insurers and fosters a common understanding and harmonization in the industry.

United Arab Emirates

Far reaching takaful regulation was introduced in the UAE which should harmonize the industry…

In the UAE, takaful-specific regulation for the local market was only introduced in 2010 with a measure called Resolution No 4. The main implications of the resolution are as follows.[6] It stipulates the formation of a Supreme Committee for Fatwa and Shariah Supervision which issues binding legal opinions (fatwas) for the takaful industry. On one hand it prohibits takaful window operations as well as composite family and general takaful companies. On the other, the resolution allows the wakalah, mudarabah and hybrid models to operate (the wakalah-waqf model is not mentioned). Furthermore, under the new law operators must provide a qard against deficit in the takaful fund and companies have to use retakaful rather than conventional reinsurance.

… but it remains to be seen how strictly enforcement will be.

The new regulations are a big step forward for the takaful industry in the UAE. It still remains to be seen how quick and strict enforcement will be, especially given the many active companies and recent regulatory enforcement.

[5] http://www.bnm.gov.my/guidelines/02_insurance_takaful/03_prudential_stds/19_guidelines_operational_framework.pdf

[6] Clyde & Co 2010, Clyde & Co, "Board Resolution No.4 of 2010 Concerning Takaful Insurance – UAE", http://www.mondaq.com/article.asp?articleid=110654

Regulation of the local market is independent of the regulation that applies to the companies in the Dubai International Financial Centre.

The new framework for the local market is independent from the takaful regulation in the Dubai International Financial Centre (DIFC). The main requirements for offering takaful products from the DIFC include: (1) specifying products and contracts, (2) appointing a shariah supervisory board, (3) implementing processes for achieving shariah compliance, (4) establishing shariah-related risk management practices and (5) adopting accounting and auditing standards set forth by the AAOIFI.

Saudi Arabia

In Saudi Arabia the regulator prescribes a special cooperative model.

In Saudi Arabia, the regulator is requiring companies to adopt the cooperative model. In practise, a number of takaful companies use wakalah and hybrid models. The takaful models do not contradict the model stipulated by the regulator and may be operated.

International bodies and regulatory agencies

In addition to the national regulators a number of industry associations and also rating agencies have issued takaful specific guidelines on accounting, capital adequacy or solvency measurement:

AAOIFI issued standards had a harmonizing effect.

The Bahrain based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is a non-profit body that prepares accounting, auditing and shariah standards. Its publications had a harmonizing effect, as Bahrain, Pakistan, Qatar and the UAE regulations are following them.

Islamic Financial Services Board has issued a standard on solvency requirement which could promote industry harmonization.

In Southeast Asia, the Malaysia based Islamic Financial Services Board (IFSB) acts as an international standard-setting body on shariah governance, risk management or capital adequacy standards. Most recently it has issued the Standard on Solvency Requirements for Takaful. The newly issued standard is aimed at global guiding principles for assessing solvency requirements of takaful companies, but it remains open how many regulators will implement the standard, as it is likely to increase capital requirements for takaful companies. (Milliman 2011)

Summary of regulatory trends

Malaysia has the most advanced regulation and will extend the RBC framework to takaful companies.

Regulation in Malaysia and Bahrain appears to be the most advanced. Malaysia is about to take another big step towards creating a level playing field with the extension of the Risk Based Capital framework to takaful companies, but there are serious concerns amongst takaful operators that the new RBC framework will significantly increase capital requirements. Takaful companies fear that the unique set-up of a takaful operation is not adequately taken into consideration in the proposed RBC framework.

Outside Bahrain and the financial centres of the region, takaful regulation is little developed or has just been introduced.

Indonesia's regulation is expected to evolve further. In contrast, outside Bahrain and the various financial centres in the Middle East, takaful frameworks are less developed. In the UAE, the takaful specific regulation has just been issued. The proposed rules address the key aspects of takaful business models and should bring more transparency and harmony among operating models, but uncertainty remains around enforcement speed and degree. The Saudi Arabian regulator has taken huge steps forward over the past four years in implementing its cooperative model, but since takaful and cooperative models coexist, consumer confusion may hamper growth.

Diversity of interpretation of shariah principles is likely to persist, unless more international coordination takes place.

The work of international bodies could support the takaful sector's global harmonization, but more coordination between the different bodies would be beneficial for the industry as a whole. However, with the differences in interpretation of shariah principles between regions and countries, diversity will likely remain a feature of the takaful industry for the next few years.

Takaful growth and performance

Market size and growth

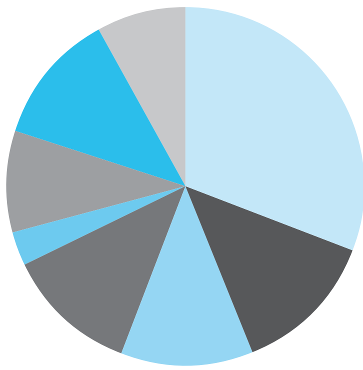
Takaful in developed and emerging non-Muslim countries is not considered in this report.

Despite a potentially significant population of Muslims living in developed, non-Muslim countries, efforts to introduce takaful products into developed countries have met with limited success so far.[7] In addition, takaful business in non-Muslim emerging markets is still very small. Therefore, these two market segments are not considered in this study.

Takaful contributions amounted to an estimated USD 3.2bn in 2010.

Market shares
Direct takaful contributions in 2010 are estimated at USD 3.2bn. This figure is based on the best available sources, using data published by regulators (Malaysia, Bahrain) and company data (UAE and Saudi Arabia). Where neither regulatory nor company data is available, the World Islamic Insurance Directory published by Takaful Re was consulted.[8] According to the latest data, Malaysia is the largest Market with USD 1bn, while the UAE, Saudi Arabia and Indonesia have similar estimated market sizes with USD 400m.

Figure 4:
Market share of countries in takaful (2010 estimates, contributions in USDm)



Malaysia	997	31%
Indonesia	405	13%
Saudi Arabia	402	12%
United Arab Emirates	404	12%
Bahrain	102	3%
Sudan	288	9%
Other Middle East	385	12%
Other Southeast Asia	247	8%

Sources: Economic Research & Consulting, supervisory authorities, company annual reports, World Islamic Insurance Directory

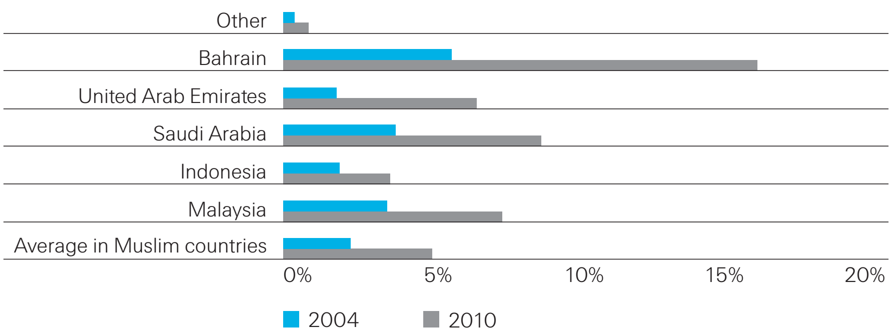
[7] Recently, Salaam Halal, the first Islamic insurance company in the UK, went into run-off in 2009.
[8] Due to lack of data, a significant amount of uncertainty remains around market estimates. Due to new data available, several market estimates have been significantly revised since the sigma No 5/2008. Notably, Saudi estimates were revised downwards while UAE estimates were revised upwards.

Strong growth in the takaful sector continued between 2007 and 2010.

Market growth
The takaful sector has continued to expand at a very strong pace of 28% annually between 2007 and 2010 (all growth rates are adjusted for inflation). This figure overshadows the much smaller 5% average growth of the entire insurance sector in Muslim countries or 8.1% in the emerging markets overall during the same period. Among the currently smaller takaful markets, such as Pakistan and Bangladesh, contribution volumes expanded rapidly. Strong growth was not confined to smaller markets, however. In Malaysia, contributions grew at almost 20% annually and Indonesia's takaful contributions increased even more quickly at an average of 33% annually. In the Middle East, both the UAE and Saudi Arabia expanded very quickly at more than 30% annually between 2007 and 2010, but growth slowed in 2010, because of Saudi Arabia's family segment.

The takaful market share of overall for insurance sector in Muslim countries has more than doubled between 2004 and 2010, from 2.3% to 5%.

Figure 5:
Takaful penetration in Muslim countries (takaful contributions as a % of total insurance premiums)



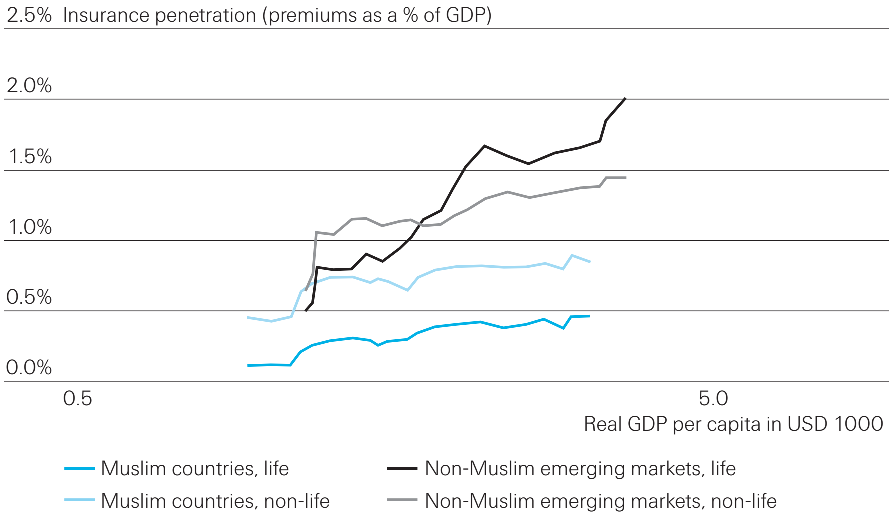
Sources: Economic Research & Consulting, supervisory authorities, company annual reports, World Islamic Insurance Directory

Insurance penetration in Muslim countries has increased more slowly than in non-Muslim emerging markets, despite their similar income levels.

The strong recent growth of takaful suggests that insurance could finally take off in Muslim countries. Since 1990, insurance take-up has been very slow in comparison with emerging markets overall. This slowness is even more perplexing when seen alongside the rapid insurance penetration increase in non-Muslim emerging markets countries. Figure 5 shows the development of insurance penetration in relation to real GDP per capita in both Muslim countries and non-Muslim emerging markets. In general, as wealth and income increases, a higher share of income is spent on life and non-life insurance. Therefore one would expect that insurance penetration in Muslim countries would increase as in non-Muslim emerging markets. However, although insurance penetration has increased both in Muslim and Non-Muslim emerging markets, a large gap in penetration level and pace of increase over time is markedly apparent.[9] The difference is even more pronounced in life than in non-life. Interestingly, neither country group shows a big difference in GDP per capita.

[9] The gap in the level and increase of insurance penetration prevails both when excluding the dominant Asian countries China and India, as well as when excluding the more advance emerging market in Central and Eastern Europe.

Figure 6:
Development of insurance penetration in Muslim countries and non-Muslim emerging markets (1990–2010)

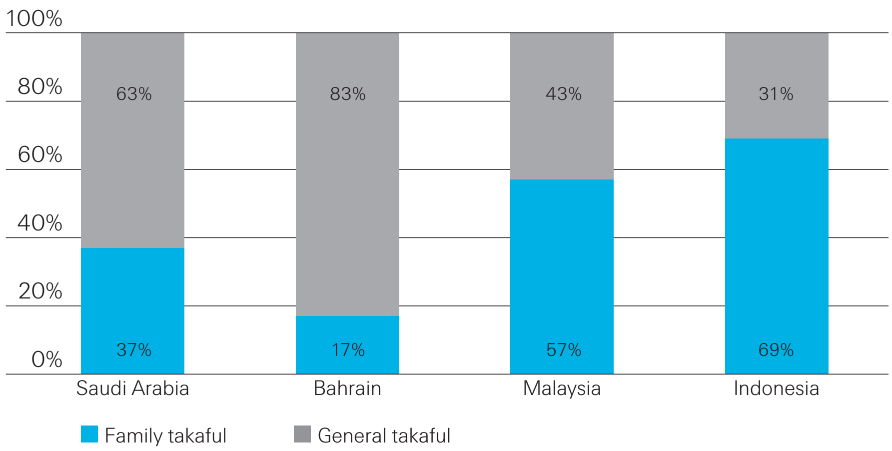


Source: Economic Research & Consulting

There are certainly many reasons that contribute to this penetration gap, but the public perception in Muslim countries that insurance is incompatible with the Islamic faith, seems to be one important factor. The development of a takaful industry could narrow the gap between Muslim markets and non-Muslim emerging markets. The takaful market, particularly in the Middle East, is still small, but strong recent growth is encouraging. For example, in Saudi Arabia and the UAE, life insurance penetration has finally begun to grow thanks to the strength of family takaful operators.

Family versus general takaful
As in the conventional life market, the family takaful segment has a higher share in Southeast Asia where life insurance is already established as a tool for savings. In contrast, the concept of family takaful is only gradually starting to take hold in the Middle East.

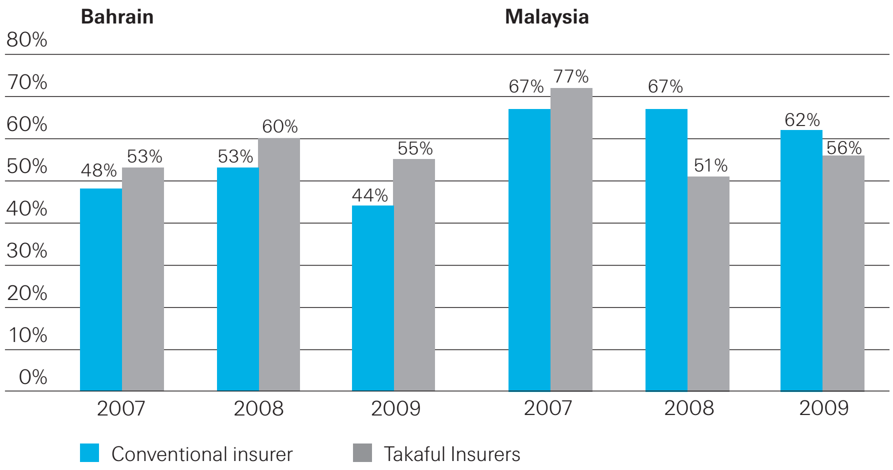
Figure 7:
Share of family and general takaful contributions in key markets (2010 estimates)



Sources: Supervisory authorities, Economic Research & Consulting

Underwriting performance
Outside Malaysia and Bahrain there are few reliable aggregate profitability measures available for the takaful industry. The industry and many companies are still in the start-up phase, and companies have yet to reach a certain size before they can operate on profitable basis. In Malaysia, where the general takaful sector is already relatively mature, the comparison can be made between takaful and conventional insurance. There, it can be observed that net loss ratios in general takaful have improved significantly since 2007 and are now lower for takaful than their non-life equivalents. In Bahrain, takaful loss ratios have been between 5 and 10 percentage points higher over the past three years.

Figure 8:
Net loss ratios for general/non-life insurance in Bahrain and Malaysia



Source: Supervisory authorities

Family takaful operators seem to be more profitable and in Malaysia, general takaful operators outperformed conventional insurance companies.

Family takaful business is estimated to generate better financial returns than general insurance, since general takaful operators tend to focus on price competition against conventional general insurers to achieve their ambitious growth targets.[10] Based on company data, the A.M. Best report concludes that Malaysian takaful companies financially outperformed their conventional counterparts, while the opposite was observed in the countries of the Gulf Cooperation Council (GCC).

[10] A.M. Best Company 2011, "Takaful market review: Takaful poised for growth, but greater focus required"

Key issues and outlook

Significant potential for takaful growth

A strong economic environment coupled with a young, rapidly growing population should favour economic growth in Muslim countries. In addition, there is a large gap in insurance penetration in the Middle East (life insurance and personal lines) and in Southeast Asia (commercial lines), not to mention a low share of takaful penetration. Even in Malaysia, the most developed market, the share of takaful of the total insurance market is below 10%.

This fertile economic environment has attracted an increasing number of multinational insurance companies to the takaful market space. Most global reinsurers have also set up retakaful operations to cater the growing industry's need for capacity and services. Sowing the seeds for re/takaful growth, shariah scholars are increasing Islamic awareness and advising companies to opt for takaful protection. Market potential can be even further extended by offering takaful to non-Muslims in general as well as Muslims in developed markets.

Key challenges

Despite the positive economic situation and strong growth of the takaful industry, key challenges persist. These challenges can be grouped into five key topics: consumers, harmonization, the financial market environment, human resources and shariah observance.

Raising consumer awareness is key in all markets.

Consumer awareness and the need for a takaful value proposition
Many consumers in Muslim countries still lack awareness of the benefits of insurance or still generally object to the concept of insurance due to religious misconceptions. Sometimes even takaful is not seen as shariah-compliant. Awareness-raising for takaful is needed, even in Malaysia where companies have been active for over 20 years. In a recent Swiss Re consumer survey of 11 Asian-Pacific markets[11], only 30% of Muslim respondents in Malaysia indicated that they have a good knowledge of takaful. In Indonesia, a mere 5% responded that they have a good knowledge of it. Despite this low awareness, the Swiss Re survey nevertheless indicates that Muslim respondents have a positive perception of the takaful industry.

Middle Eastern countries were not included in the survey, but similar results would be expected given that the takaful industry is much younger there. Takaful companies need to develop a distinct value proposition that addresses the specific needs of their prospective clients and raises consumer awareness. Communication of a clear value proposition is even more important in areas where takaful competes with an established conventional insurance sector, particularly in non-life. Simply using price to compete is not an option since takaful operators tend to be smaller and do not have the same economies of scale as conventional players. Additionally, takaful companies often incur higher operating costs than conventional companies due to additional expenses for shariah compliance.

Simply designed and transparent products are needed to deliver takaful.

Aside from awareness raising and a strong value proposition, takaful product innovation is needed. In Malaysia, health, endowment, and annuity products are underserved in family takaful. In general takaful companies will need to adapt to motor deregulation. In the Middle East, innovative family takaful products are needed that address the specific needs of the Muslim population. Another area where takaful operators could become more active is microtakaful, which provides financial protection to people with low income.[12] In the longer term, takaful can also address the issue of aging and longevity by developing long-term savings products. In order to uphold the ethical standards of Islamic law, products should be designed in a simple and transparent way, without loopholes embedded in the fine print of contracts

[11] The full results of the survey have been published in August 2011 and are provided upon request.
[12] Swiss Re *sigma* No 6/2010, "Microinsurance - risk protection for 4 billion people"

Greater operational model harmonization is needed.

Harmonization

Takaful companies have been tending towards hybrid business models. However, concrete implementation deviates significantly from company to company. For example, fee types and structures as well as the rules around surplus distribution vary. Since diversity is an inherent aspect of Islam, complete standardization is neither desirable nor is it likely to be achieved. Nevertheless, more harmonization and the development and application of international takaful standards would greatly benefit the industry. Greater harmonization would lower consumer confusion, enhance cost efficiency of operations, and help from the retakaful standpoint as well.

Harmonization in retakaful

Harmonization is not only necessary in takaful but also in retakaful. A recent congregation of well-known shariah scholars and retakaful practitioners came up with the following resolutions aimed at driving harmonization:[13]

1. Retakaful contracts should be made according to shariah principles and should reflect the basis of takaful.
2. Retakaful companies should not provide any cover to conventional insurers.
3. Retakaful companies should only accept shariah-compliant policies.
4. Retakaful operators should not set up an individual fund for a single takaful operator.
5. From a shariah perspective, a qard is not the contractual responsibility of the retakaful operator. Nevertheless, an operator may provide the fund a qard if the pool is in deficit.
6. Retakaful operators should not distribute any surplus to individual participants if the pool is in deficit.
7. Retakaful operators should not have conventional retroinsurance cover in place unless it is legally required. When the law requires it, retakaful should only have conventional retro cover up to the extent of the legal need. Such matters should always be referred to the shariah Board for approval and guidance.
8. Retakaful operators should not provide profit commission for an individual treaty as this is not shariah compliant.
9. Retakaful operators should not give a certain predetermined percentage of surplus to an individual operator. Instead, they can allocate a certain percentage of the overall fund surplus to the reserves and for distribution among the participants.
10. Ex-gratia payments should be referred to the shariah Board.

For takaful to succeed in developed countries with multicultural Muslim populations or even with non-Muslims, further harmonization will be a key factor. Converging regulatory practises on takaful could support this process. However, in many countries, the regulatory environment is not yet conducive enough to the development of takaful. Also, in countries where specific regulations exist, too little emphasis is placed on the differences between takaful and conventional insurance.

[13] Shariah meeting in Dubai on 29 June 2011, including the members of the shariah boards of the retakaful operations of Munich Re, Hannover Re and Swiss Re.

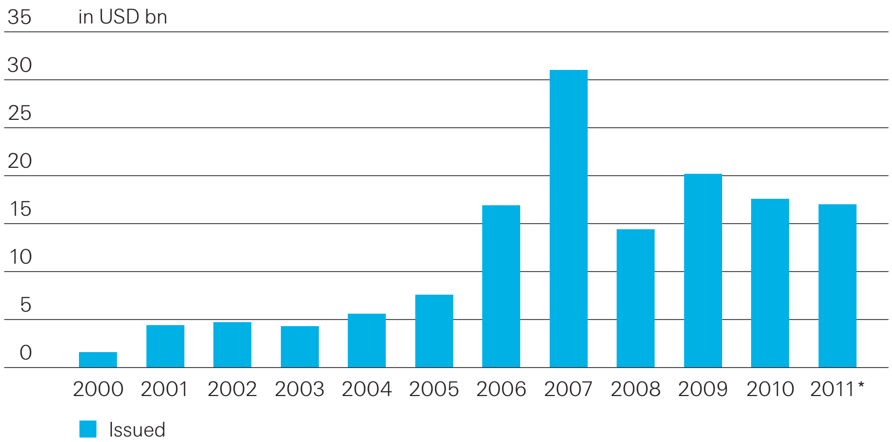
A broad range of shariah-compliant investment opportunities is needed.

The financial market environment

Insurance companies need access to a wide range of liquid financial assets for investment. Returns from invested assets need to match liabilities from underwriting activities in terms of duration and currency denomination as closely as possible. To achieve this, conventional insurance companies typically invest in fixed interest bonds, to which Islamic bonds (sukuk) are the shariah-compliant equivalent. On the one hand, the growing takaful industry will create demand for shariah-compliant investment opportunities and help develop the whole financial sector. Conversely, the takaful industry is dependent on well-developed Islamic capital market.

The volume of sukuk issued has increased strongly over the past decade. After the drop of new issuance in 2008, volumes have recovered but have not yet reached the pre-crisis level. Total outstanding sukuk in 2011 are estimated at USD 180bn.

Figure 9:
Islamic bonds (sukuk) issued



Source: Bloomberg
* Issues year to date, + based on average duration

While the overall volume of sukuk should be sufficient for the current size of the takaful industry, some challenges lie ahead. Sukuk are not frequently traded, but mostly held until maturity by their mostly institutional investor base. Competition for new sukuk in the primary market and low liquidity in the secondary market make it costly to invest. Another challenge is that the outstanding sukuk are denominated in a few currencies only: 61% are in Malaysian ringgit and 21% of total outstanding sukuk are in USD while the rest are in the remaining GCC country currencies. This currency issue is particularly important for takaful companies in smaller markets in terms of asset-liability management, where such companies are exposed to currency fluctuations. Other options include holding cash with lower returns or investing in riskier asset classes, such as volatile equity and real estate markets.

Qualified shariah scholars and staff are scarce.

Human resources
Trained shariah scholars and qualified staff with knowledge of insurance and shariah remain scarce. Although there are ongoing efforts to establish takaful education programs, the gap will take time to bridge. Consequently, many shariah scholars hold supervisory board positions in several different companies. While having one person sit on many boards is beneficial for the harmonization of operating models and eases the expert shortage, takaful law in the UAE and takaful regulation in Malaysia actually forbids this practice of holding more than one board position. These latter regulations are likely to intensify the shortage of qualified scholars.

Strict observance of shariah principles is important. Otherwise the integrity of the industry could be questioned by consumers.

Shariah observance
Takaful and retakaful are still young industries and consequently many conventional practices have been applied to them. Over-time however, takaful sector practices should be developed from within the industry, so that mutual risk sharing and joint assistance among participants can be placed at the core of the business. One example is that conventional reinsurance is still often used by takaful companies, although today sufficient retakaful capacity for most lines of business is available. Consequently, takaful companies no longer need to apply the law of necessity (dharurat), and choose conventional reinsurance, but can rather opt for retakaful solutions. If this is not done, consumers could question the integrity of the industry and perceive takaful as being the same as conventional insurance. Stressing the difference between takaful and conventional insurance is particularly important, if takaful is being marketed to non-Muslims as an ethical alternative.

Outlook

Despite manifold challenges, growth is expected to continue.

Despite the various challenges, takaful market share growth is expected to continue. Low insurance penetration, low share of takaful business in each market, and recent dynamic development of the industry will all benefit the growing takaful sector. Active support from regulators and governments, as well as strengthened takaful frameworks should support growth in the medium to long-term. Nevertheless the process will be gradual and is likely to continue changing over the next decade until the sector has achieved critical mass. Particularly, consumer awareness-raising for takaful will be a lengthy process.

Takaful should continue to outperform in terms of market growth, reaching USD 7bn of contributions by 2015.

Takaful is expected to outpace the conventional sector over the next decade, particularly where the industry is relatively well established. Based on the macroeconomic outlook and takaful and conventional insurance market analysis, takaful premium volume could surpass USD 7bn by 2015. In markets where the takaful industry and companies reach critical mass, growth is likely to be strongest. In Malaysia the outlook remains highly positive. A shift from the current bank-based distribution (bancatakaful) of family products which is focused on single premium products to a more agent based distribution could help to grow the relatively small regular premium business and diversify the business. Malaysia will remain the largest market in Southeast Asia. Strong growth can however also be expected in Indonesia, where takaful contributions could reach USD 1bn by 2015. Saudi Arabia is set to become the largest market in the Middle East followed by the UAE. The increase in takaful penetration is likely to be strongest in Bahrain, thanks to its solid regulatory framework. However, overall we still expect takaful penetration in Muslim countries to remain relatively low at 7%. If the challenges outlined above are addressed by the takaful industry and regulators, contributions could again double by the end of the decade.

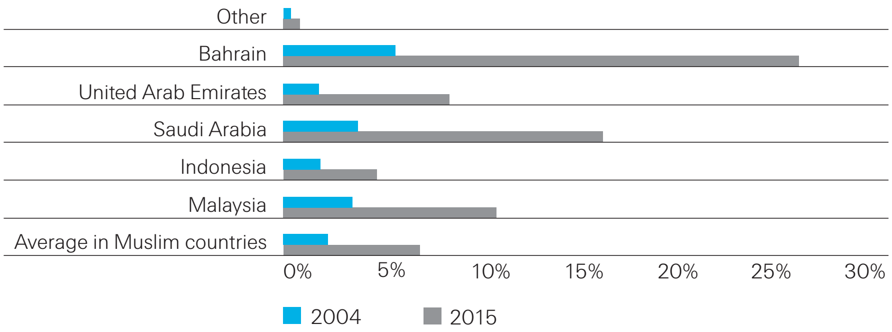
More harmonization is needed so that takaful can succeed beyond today's key markets.

For the extension of takaful to developed countries, with their heterogeneous Muslim populations, to succeed, it will be paramount to develop a more homogenous and harmonized understanding of takaful. In this process, multinational re/insurance companies could play an important role.

A global economic slow-down or recession would also drag down takaful growth.

Uncertainty in the global economy is currently very high, with the real possibility of another recession in developed countries on the horizon. A recession or marked slow-down in developed countries would weigh on growth in the emerging markets and is likely to lead to slower growth of the takaful sector as well.

Figure 10:
Outlook for takaful penetration in Muslim countries (takaful contributions as a % of total insurance premiums)



Source: Economic Research & Consulting

Glossary

Glossary of Islamic insurance[14]
Fatwa: ruling of religious and legal scholars clarifying a particular matter by interpreting the principles of shariah, with the aim of subsequent application of the conclusions to the practical life of the Muslim community.

Fiqh: the Islamic doctrine of rules of conduct and set of Islamic social rules (Islamic law).
Gharar: element of uncertainty in the subject matter of a contract or in regards to the price of the goods, or any speculative risk. For instance, gharar is present when the seller sells goods that he does not currently possess (fish in water etc), or if the performance of obligations under an agreement is conditional on the occurrence or non-occurrence of a certain event. There is no agreement among scholars as to the degree of gharar that renders the contract void.

Halal: actions permissible or acceptable from the point of view of shariah.

Haram: conduct and actions prohibited from the point of view of shariah.

Maisir: initially, a game of chance that was common in pre-Islamic times among the Arabs. In the broad sense: any action aimed at making an easy material gain (without investing work or capital).

Mudharabah: contract under which the owner of surplus cash entrusts it to a person who has the possibility and business experience to put it to efficient use. Revenues from the invested funds are shared between the parties in accordance with previously made profit-sharing agreements. Losses are borne by the provider of the capital, who does not receive any compensation for his efforts.

Qard: interest-free loan provided either as charity or for the short-term financing of potentially lucrative projects. The borrower simply has to repay the borrowed sum at the specified time. If the lender is aware that the borrower is unable to repay the debt, the means provided as qard can be considered as a voluntary or compulsory donation.

Riba: in a loan contract, interest on the principal charged by the lender when providing funds to the borrower.

Tabarru: any voluntary provision of funds based upon the mutual consent of the parties and the type of donation. Tabarru is the basis of the takaful contract.

Takaful: system based on the principles of solidarity and mutual assistance, under which the parties to the contract support each other when any of them suffers a loss.

Wakalah: an agency contract which may include in its term a fee for the agent.

Waqf: the property declared as waqf ceases to be the property of the donor, but does not become the property of the recipient. Ownership is effectively suspended. Any concrete object can be declared as waqf if it cannot be destroyed by usage and cannot lose its value over time. Such an object is considered to be the property (milk) of Allah, while the recipient of waqf (person or institution) has the rights to it. The waqf contract is terminated when the waqf property is destroyed or loses the qualities that are required for its intended purpose.

[14] Sources: Bekkin R. I., Ph. D. in Law, Moscow State University of International Relations, Ministry of Foreign Affairs of Russian Federation http://www.takafol.ru/eng/rubrika.php?rub=47 and Archer, Simon and Karim, Rifaat Ahmed Adbel. (Eds). (2002). Islamic finance, innovation and growth, London: Euromoney.

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