Swiss Re

sigma

No 5/2008

Insurance in the emerging markets: overview and prospects for Islamic insurance

Published by:
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The editorial deadline for this study was 8 October 2008.

sigma is available in English (original language), German, French, Italian, Spanish, Chinese and Japanese.

sigma is available on Swiss Re's website: www.swissre.com/sigma

The internet version may contain slightly updated information.

Translations:
CLS Communication

Graphic design and production:
Swiss Re Logistics/Media Production

Executive summary

Part I: Insurance in the emerging markets

In 2007, solid growth continued in both life and non life.

Since the turn of the century, growth in the insurance industry has been solid in the emerging markets. Both the life and non-life sectors have experienced double-digit annual average growth rates, with South and East Asia clearly leading in both consistency as well as pace.

Sales of investment-linked life products and new compulsory non-life products spurred growth.

In 2007, at the dawn of the credit crisis, total premium volume in the emerging markets had grown 13% in real terms over the previous year (life 14%, non-life 12%). In most regions, growth had eased somewhat. In many countries, the strong performance of the stock markets in the first three quarters of 2007 supported sales of investment-linked life products. The non-life sector benefited from the strong economic environment and the introduction of new compulsory lines especially in the Middle East.

Recent developments include risk-based capital regimes, the expansion of microinsurance and growth of bancassurance.

Recent market developments include the decision by some regulators in the emerging markets to enhance the capital base of the industry by introducing more stringent capital requirements – eg risk-based capital regimes. Other developments include the expansion of microinsurance, which extends coverage to low-income individuals, and the growing popularity of bancassurance as a distribution channel.

The financial crisis will lead to an economic slowdown…

However, the financial crisis is clouding the near-term outlook. The economic slowdown in the industrialised countries will lead to reduced demand for products exported from emerging economies and hinder economic growth. Additionally, the global slowdown has resulted in lower commodity prices, which should lead to lower inflation. Nevertheless, elevated inflation remains an issue in some countries in the Middle East and Eastern Europe.

…and adversely impact insurance growth in the emerging markets.

As a result, insurance in the emerging markets is expected to grow at a slower pace in 2008 and 2009, though the longer term perspective remains positive. While the steep economic slowdown in Vietnam has created some concerns, the Asian economies are stronger today than they were a decade ago during the last Asian financial crisis. Due to the strong export sector, most Asian economies have large foreign-exchange reserves and current account surpluses. Therefore, a second Asian crisis is unlikely.

Part II: Islamic insurance – market overview and prospects

While conventional insurance is incompatible with Islamic law, takaful is an accepted form of insurance coverage.

According to Islamic jurists, conventional insurance is not aligned to the shariah, the body of Islamic law. As a result, roughly 1.5 billion Muslims around the world are underserved by the insurance sector. Although various Islamic insurance versions have been adopted in Muslim countries, takaful, a form of financial protection based on mutual assistance and joint risk bearing, is the most accepted model of shariah-compliant insurance. While takaful is based on mutuality, and is in some respects similar to mutual companies, the vast majority of takaful companies today operate as stock companies.

Takaful has the following features: a separation between policyholder funds (ie takaful funds) and shareholder funds, a shariah-compliant investment strategy (by avoiding the payment of interest and firms engaged in forbidden activities) and an internal supervision board of shariah scholars. In the three prevailing takaful models, the operator receives a fee (the wakalah model), a share of the profits (the mudarabah model) or a combination of both (hybrid model).

Takaful is growing in popularity.

In 2007, Muslim countries accounted for 23% of the emerging markets' GDP. About 11% of insurance premiums (ie USD 45bn) were written in these countries. Of this amount, roughly 4% (ie USD 1.7bn) were written under takaful schemes. Between 2004 and 2007, the average annual growth rate for takaful was estimated at 25% (adjusted for inflation), versus 10.2% in the conventional market.

Five markets are analysed; the two markets with the largest takaful growth potential are Malaysia and Saudi Arabia.

For this *sigma*, five markets were analysed in detail: Bahrain, Indonesia, Malaysia, Saudi Arabia and the United Arab Emirates. The two takaful markets with the largest growth potential are Saudi Arabia and Malaysia, although their insurance markets are at very different stages of development. Commercial lines of business and non-life insurance dominate the market in the Middle East; in Malaysia, however, life insurance and personal lines of business are the most prevalent. Insurance awareness is higher in Malaysia than in the Middle East, where the uptake of insurance by individuals – beyond the compulsory lines of business – is very low due to religious objections to conventional insurance. Because of this, demand for takaful in the Middle East is set to grow in the medium to long term.

Growth of takaful is hampered by the lack of investment opportunities; staff are needed with shariah expertise as are solutions for coping with large risks.

Among the major challenges to the growth of takaful are the shortage of Islamic investment opportunities and the lack of liquid markets for Islamic bonds in different regions. Staff with insurance and shariah expertise, shariah scholars and solutions for coping with large risks are also needed. In order for the global takaful industry to prosper, further standardisation of the operating models is required. Moreover, varying interpretations of Islamic law remain a challenge. Until recently, a lack of available retakaful capacity had hampered the industry. Over the last three years, however, most major reinsurers have put retakaful solutions in place.

Takaful is expected to appeal to Muslims who would not have considered conventional insurance.

Initially, takaful may create some leakage for conventional insurers, particularly in non-life, and may also be attractive to those of other religious denominations. In the medium term, and particularly in life, takaful is expected to stimulate additional demand by catering to Muslims who otherwise would not have considered conventional insurance. If the economic outlook in the Middle East and Asia remains positive, the global takaful market could reach USD 7bn by 2015.

Insurers can leverage their expertise in conventional insurance in the takaful market.

The technical aspects of underwriting takaful are similar to those of conventional insurance. Conventional insurers can therefore tap into the takaful market by setting up branches or subsidiaries and leveraging their technical expertise in underwriting and distribution. Insurers should also be able to leverage their reputation and capital strength.

Global insurers might consider how to best serve Muslims around the world, regardless of where they may live.

Although it is not the focus of this sigma, global insurance companies involved in takaful might consider how to best serve the Muslim population throughout the world. An estimated 5 million Muslims reside in France; another 3 million live in the UK. Without a global standard for takaful, it will be challenging to serve a population with such a diverse background.

Introduction

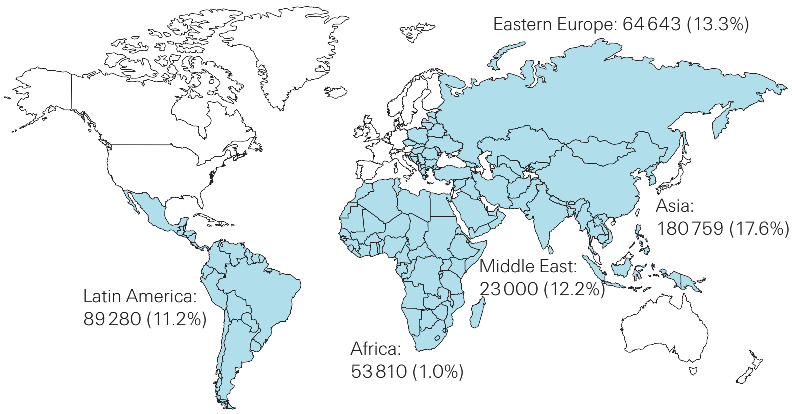
This *sigma* focuses on recent economic trends and developments in the emerging markets.

This *sigma* continues the series on insurance and economic trends in the emerging markets. The first part covers the latest developments in the insurance industry and the economy. The second part is devoted to the insurance markets in Islamic countries and insurance models complying with the shariah, the body of Islamic law. Led by the banking sector, Islamic finance has developed rapidly in recent years. The driving forces have been the increasing prosperity across the emerging markets and the rise in oil prices. The financial sector in Muslim countries has also developed rapidly and increased the awareness of Islamic offers. Although Islamic insurance is expected to expand to the industrialised countries, the focus here is on the emerging markets, home to 98% of the world's Muslim population.

Definition of emerging markets

The following regions are covered: Asia, excluding Japan and the newly industrialised Asian economies[1], Latin America and the Caribbean (referred to as Latin America), Central and Eastern Europe (referred to as Eastern Europe), the Middle East, Central Asia and Turkey[2] (referred to as Middle East) and Africa.[3]

Figure 1:
Insurance premiums in the emerging markets (coloured) amounted to USD 422bn in 2007. Regional premium volume in millions, with real growth in 2007 in brackets



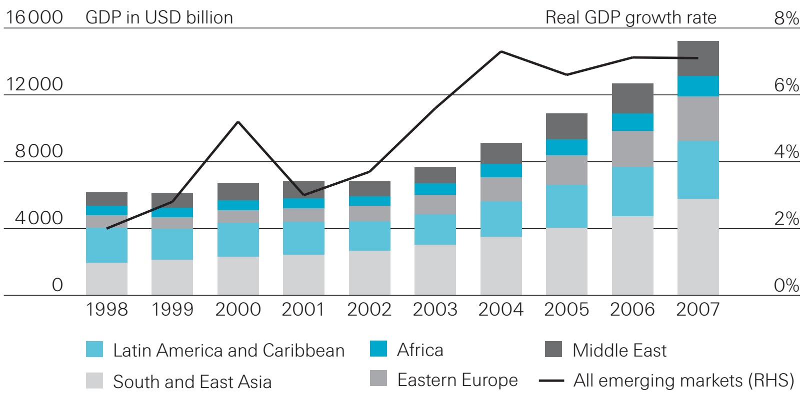
Source: Swiss Re Economic Research & Consulting

[1] Hong Kong, Singapore, South Korea, Taiwan
[2] Israel is excluded from this region.
[3] The classification of emerging markets in this report is consistent with the IMF's and differs from that in Swiss Re, *sigma* No 1/2007 "Insurance in emerging markets" where the newly industrialised Asian economies were included. The figures in this study may also differ from Swiss Re, *sigma* No 3/2008 "World insurance in 2007", due to newly available data and revisions.

Strong economic growth continued in 2007.

In 2007, the emerging markets' gross domestic product (GDP) expanded by a robust 7.2% in real terms, the same pace as the previous year. Growth was solid across all regions, with South and East Asia (+9.7%) growing only marginally slower than the previous year. The economies of Eastern Europe (+6.8%) and Africa (+6.7%) expanded at a slightly slower pace, followed by the economies of the Middle East (+5.1%) and Latin America (+5.1%). The combined GDP of emerging market economies climbed to USD 15 200bn in 2007, contributing more than 28% of the world's economic activity. The importance of the emerging market economies is further enhanced by the fact that China and Brazil are now the fourth and tenth largest economies in the world.

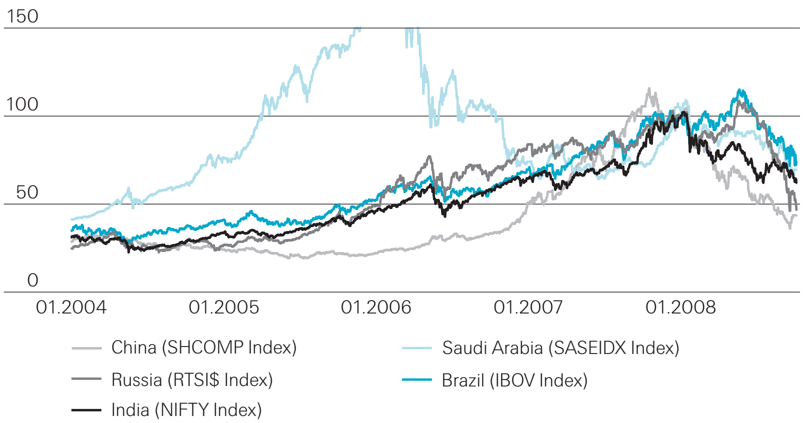
Figure 2:
GDP in USD bn and real GDP growth in the emerging markets. 1998–2007



Sources: Oxford Economic Forecasting; WIIW; Swiss Re Economic Research & Consulting

The credit crunch in the United States has triggered capital outflows from many emerging economies, and is likely to continue. The stock markets of the emerging market leaders during the boom – ie China, India, Vietnam, Saudi Arabia and Brazil – have already experienced sizable slumps since late 2007.

Figure 3:
Stock markets in the emerging markets: Strong in 2007, large losses in 2008.



Source: Datastream

Inflation is a concern in some emerging market economies.

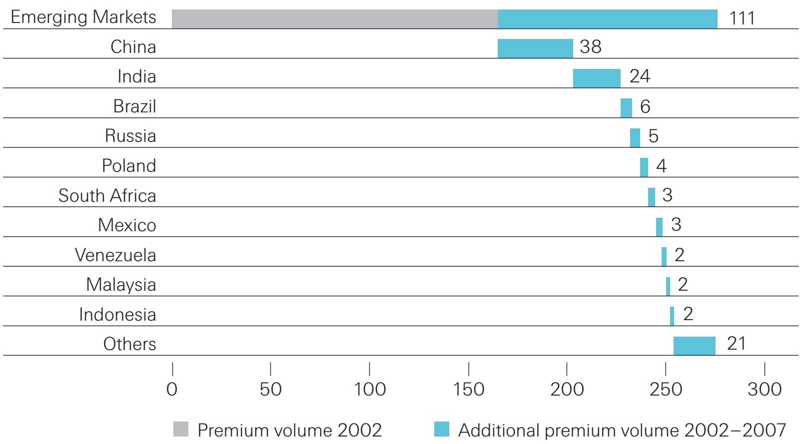
Continuously driven by elevated commodity prices, inflation across the emerging markets increased in 2007. High oil prices pushed up prices everywhere, creating enormous fiscal burdens for Asian and Latin American governments with fuel subsidy programmes. In fact, the high price of oil forced countries like Indonesia and Malaysia to cut their funding for such programmes. Surging food prices have also contributed to inflation. Due to the higher weighting of food and energy in the household budgets of emerging economies, consumer spending has declined. Consequently, the focus of governments has shifted from stimulating economic growth to also keeping inflation in check and mitigating social instability in these markets in 2007.

Insurance sector continued to grow

Emerging market insurance growth remained robust in 2007.

Since 2002, premium volume in the insurance sector of the emerging markets has more than doubled, reaching USD 422bn in 2007. At 2002 prices, and adjusting for inflation, China (USD 38bn) and India (USD 24bn) contributed the most to premium growth. The other two superpowers in the emerging markets, Brazil and Russia, also contributed USD 6bn and USD 5bn, respectively. In fact, the ten largest countries accounted for 80% of all additional premiums, thus highlighting the importance of the large markets to the sector.

Figure 4:
Contribution to emerging market premium growth 2003–2007 (at 2002 prices)



Source: National insurance authorities, Swiss Re Economic Research & Consulting

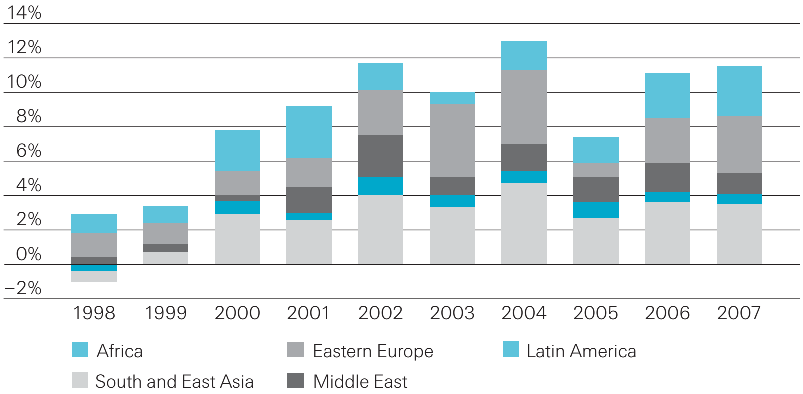
Non-life market grew steadily in 2007.

Non-life market growth

In real terms, emerging market premiums in the non-life sector grew by 11.6% in 2007. This was slightly above the average of the five previous years. South and East Asia (+13%), Eastern Europe (+12%) and the Middle East (+12%) grew the fastest. The strong economic fundamentals in 2007 helped to stimulate demand for non-life insurance in these regions.

The implementation and enforcement of compulsory insurance protection in health, motor and some liability lines contributed significantly to the growth of the non-life sector in the Middle East.

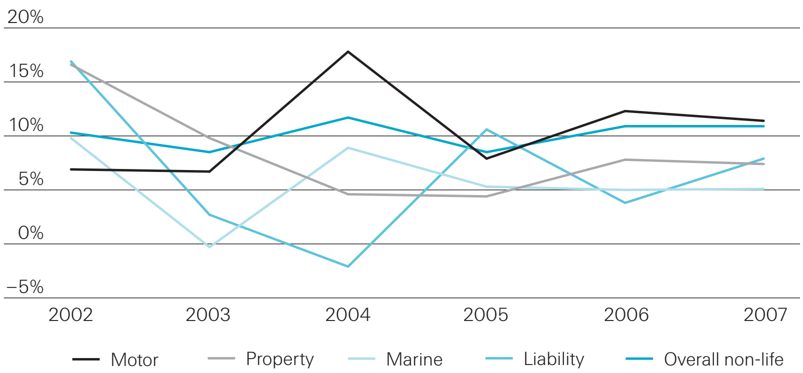
Figure 5:
Regional contribution to emerging market non-life real premium growth, 1998–2007



Source: National insurance authorities, Swiss Re Economic Research & Consulting

The motor and property businesses continued to dominate the emerging markets insurance landscape in 2007. Motor insurance outperformed the non-life market as a whole because it is usually the first to benefit during an economic expansion. In the Middle East, Turkey and China, motor third party liability (MTPL) coverage is now mandatory.

Figure 6:
Premium growth of the major business lines



Source: National insurance authorities; Swiss Re Economic Research & Consulting

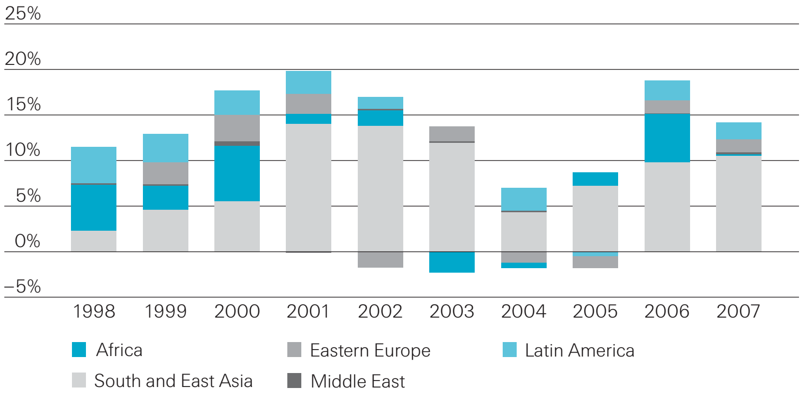
Life insurance continues to grow, albeit at a slower pace.

Life market growth

Growth in the life market slowed from its 2006 level of 19% to 14% in 2007, which was still above the average between 2002 and 2006. Premium volume in 2007 amounted to USD 223bn. As in non-life, the solid economic fundamentals contributed strongly to growth. In particular, the strong performance of the stock markets during the first three quarters in 2007 stimulated sales of investment-linked products. The launch of new products and the increasing market shares in bancassurance, also contributed significantly to the sector's results.

Most of the regions decelerated only marginally from their record high levels of the previous year. In South and East Asia, Indonesia (+57%) grew the fastest in 2007. In the second largest market, India, new business growth slowed significantly from 145.7% in fiscal year 2006 to just 9.6% in fiscal year 2007.[4]

Figure 7:
Contribution to emerging market life real premium growth, 1998–2007



Source: National insurance authorities

Insurance penetration and expenditure

Strong economic fundamentals and regulatory issues contribute to insurance spending,

In the emerging markets, strong economic fundamentals and regulatory issues, such as the enforcement of compulsory insurance, contributed to the increase in insurance spending. Per-capita spending in the non-life sector rose from USD 28.3 in 2006 to USD 34.9 in 2007. Non-life spending was highest in Eastern Europe and lowest in Africa and South and East Asia (see Table 1). Overall, per-capita spending in the life sector was higher. In the emerging markets, it climbed from USD 31.2 in 2006 to USD 39.1 in 2007. Expenditure on life insurance was highest in Latin America and lowest in the Middle East. The differences, however, are not as big as in non-life.

[4] Fiscal year: April 1–March 31

Table 1:
Insurance density: emerging markets vs. industrialised markets

Premium per capita – USD	Life insurance 2007	Non-life insurance 2007	Life insurance 2006	Non-life insurance 2006
Industrialised markets	2218.0	1434.1	1969.4	1365.8
Emerging markets	39.1	34.9	31.2	28.3
South and East Asia	37.0	15.2	27.7	12.2
Latin America	63.4	94.0	51.3	76.4
Eastern Europe	56.0	173.5	40.5	134.0
Africa	39.1	16.8	39.0	15.3
Middle East	19.4	57.5	16.2	48.3

Source: National insurance authorities; Swiss Re Economic Research & Consulting

Life insurance penetration increased in South and East Asia, Eastern Europe and Latin America from 2006 to 2007. In Africa, however, penetration fell from 3.4% to 3.0% (see Table 2), due to the significant slowdown in the South African insurance market. Non-life insurance penetration remained constant in most regions, although it experienced mild growth in Latin America, Eastern Europe and the Middle East in 2007.

Table 2:
Insurance penetration: emerging markets vs. industrialised markets

Insurance penetration – Premiums as a % of GDP	Life insurance 2007	Non-life insurance 2007	Life insurance 2006	Non-life insurance 2006
Industrialised markets	5.6%	3.6%	5.4%	3.7%
Emerging markets	1.5%	1.3%	1.4%	1.3%
South and East Asia	2.2%	0.9%	2.0%	0.9%
Latin America	1.0%	1.6%	1.0%	1.4%
Eastern Europe	0.7%	2.1%	0.6%	2.0%
Africa	3.0%	1.3%	3.4%	1.3%
Middle East	0.1%	1.0%	0.1%	0.9%

Source: National insurance authorities; Swiss Re Economic Research & Consulting

The top ten markets in the life sector accounted for more than 85% of the total life premiums in 2007, which is much more than the top ten markets in the non-life sector (see Table 3). China continued to be the biggest market, for both life and non-life. Its strong economic growth and relatively low level of insurance penetration favour its medium and long-term growth. Since 2004, the market shares of the top ten countries have remained fairly constant, with the exception of India, which moved up the rankings in both life and non-life.

Table 3:
Top ten countries in non-life and life insurance

Life insurance	2007 premium volume (in USDm)	Share of emerging markets
China	58673	26.4%
India	51322	23.0%
South Africa	34430	15.5%
Brazil	18533	8.3%
Poland	7950	3.6%
Mexico	7653	3.4%
Malaysia	5573	2.5%
Indonesia	4728	2.1%
Thailand	4521	2.0%
Chile	3792	1.7%
Top 10	197177	88.6%

Non-life insurance	2007 premium volume (in USDm)	Share of emerging markets
China	33810	17.0%
Russia	28973	14.6%
Brazil	20501	10.3%
Mexico	9763	4.9%
South Africa	8345	4.2%
Poland	7677	3.9%
India	7402	3.7%
Turkey	7201	3.6%
Venezuela	6977	3.5%
Argentina	4471	2.2%
Top 10	129619	68.0%

Source: National insurance authorities; Swiss Re Economic Research & Consulting

Recent market developments

Solvency regulation

Solvency regulation in most emerging markets is becoming more stringent.

Many of the regulators in the emerging markets have pushed for the introduction of more stringent capital requirements. Risk-based capital (RBC) regimes[5] have been discussed in a number of markets, such as Brazil, Chile, Malaysia, the Philippines and Thailand. In Malaysia, the discussion about RBC has been extended to takaful and is expected to be introduced in 2010 or 2011. The Brazilian government has also unveiled its revised RBC requirements, which it plans to implement in 2010. The Eastern European EU members are already applying the Solvency I regulation of the EU and will implement Solvency II. Also, the governments of Mexico and Chile are moving towards a Solvency II regime. The implementation of RBC and Solvency II regimes are expected to enhance the industry's capital base and lead to increased market consolidation in some highly fragmented markets.

[5] For an overview of the different capital and solvency regimes, see Swiss Re *sigma* No 4/2006 "Solvency II: an integrated risk approach for European insurers".

Microinsurance is gaining in popularity in Latin America, Africa and Asia.

Microinsurance

Microinsurance, which provides insurance coverage for low-income individuals, is gaining in popularity in Latin America and Africa. Insurers in Asia are also entering this market, and have launched more microinsurance products in Indonesia, China, India, Sri Lanka and Thailand. Specifically, China Life, the market leader in China, will launch a pilot microinsurance programme to offer life and health coverage to rural families in nine provinces. After this initial test phase, the plan is to extend coverage throughout the country.

Many potential customers would like to have insurance coverage, but cannot afford conventional insurance products. Microinsurance products, in comparison, tend to be much cheaper and make risk coverage affordable for a much wider audience. This is especially true in Muslim countries, such as Indonesia, where microtakaful could further increase the appeal of takaful (see part II).

Bancassurance is also gaining in importance in the emerging insurance markets.

Bancassurance

Bancassurance, the provision of insurance services by banks, is an established and growing channel for insurance distribution. Bancassurance has continued to gain in popularity in the emerging markets. In Asia, about 28% of the life business and 2% of the non-life business was generated through this channel in 2005. In China alone, bancassurance accounted for more than 50% of all new life business in the first half of 2008. Concerns about the cost of using agents and the banks' desire to broaden their income base have been the major drivers of bancassurance growth.

Outside Asia, bancassurance is gaining in importance as the primary distribution channel in the life business, though this is not the case in the non-life sector. In Turkey, bancassurance has rapidly gained in importance since 2004, where it is now the largest distribution channel for life insurance, accounting for 38% of the market in 2007. In Poland, 23% of the life business was generated through bancassurance in 2007, up from 14% in 2006. In Latin America, sales through this channel have also been strong in both Chile and Brazil. The acceptance of bancassurance, however, has been mixed in other regions. Regulatory constraints are an issue in the Middle East countries. The distribution of investment-linked products in Saudi Arabia is only allowed via banks, whereas in Egypt, banks are not allowed to actively sell life insurance, nor may they receive commissions on sales.

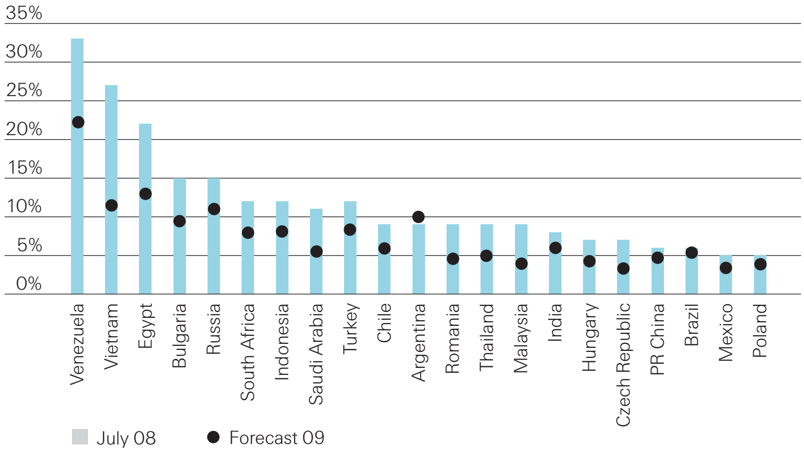
Economic and insurance growth

The US sub-prime crisis will definitely impact the global economy throughout 2009.

The credit crisis, which began in 2007, has become the most severe financial crisis since the 1920s. It is expected to have a negative impact on the global economy throughout 2009. Growth of emerging economies remained stable in the first half of 2008; however, the impact of the financial turmoil will only be fully reflected in the coming quarters. The industrialised economies that are most affected by the market turbulence have slowed significantly. Emerging markets, particularly those countries that rely heavily on external financing and exports, will be similarly affected.

The economic growth of emerging markets is expected to be affected by slower foreign direct investments (FDI) and exports. Nevertheless, looser monetary and fiscal policies would help these emerging markets to sustain moderate growth in 2009. The inflationary pressure in many of the emerging markets, however, remains a concern. Food and oil prices have weighed heavily on inflation in Asia, though this is likely to ease in a global economic downturn.

Figure 8:
Elevated inflation across the emerging markets to ease in 2009



Source: Oxford Economic Forecasting, Swiss Re Economic Research & Consulting

Therefore, emerging markets growth is not to remain at its previously high levels. Growth is expected to slow from 6.2% – the average between 2002 and 2007 – to below 6% between 2008 and 2013. There will be material downside risks in the medium term, due to the financial turmoil and the impact of the industrialised countries on export demand.

The recent financial turmoil highlights the vulnerability of emerging markets.

Although the low costs of capital and financing over the last few years had driven growth in the emerging markets, the recent tightening of credit and rising spreads are now creating concerns about the financial stability of some of these markets. Earlier this year, rising apprehension about Vietnam's rising inflation and current account deficit fuelled concerns of an impending financial crisis, which highlights the fragility of investor confidence. While significant uncertainties remain, an analysis of the financial condition of Asian emerging markets today and before the 1997/1998 Asian financial crisis shows that these markets are now resilient to external shocks (see box).

Slowdown of non-life insurance growth; solid medium-term outlook for life

The economic slowdown could lead to lower non-life insurance demand…

The economic slowdown will have a negative impact on the demand for personal and commercial non-life insurance products in 2008. The impact of the financial turmoil will only be fully reflected in 2009. The international insurers hit by the credit crisis may face liquidity constraints, which could force them to postpone their overseas expansion.

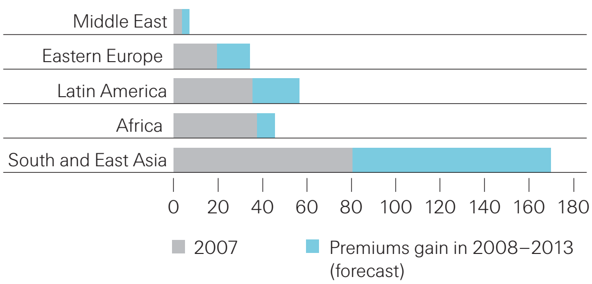
…while sales of investment-linked products will be adversely impacted by the lack of investor confidence.

The sales of single-premium products and/or investment-linked products have contributed to growth in the life sector during the investment boom of the past few years. The diminishing role of these products as alternative investment tools, however, will inevitably hamper the insurance market in the short term. In Eastern Europe, the steep drop in stock prices during the first three quarters of 2008 has negatively affected unit-linked sales. In Brazil, however, the market has continued to grow due to tax incentives. In Asia, China's life insurance sector, which accounts for about half of the region's premiums, continued to grow strongly into 2008. In the medium to long term, the outlook remains positive due to the increasing awareness of insurance products, the gradual increase in wealth and the expected reduction in state social security benefits; these developments will increase the need for life protection. While falling sales of unit-linked products reflect the serious drop in stocks across all markets, their decline will also have a negative impact on assets and capital gains/losses.

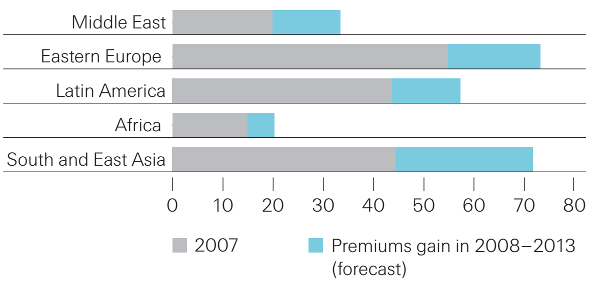
Factoring in these considerations, the growth of the life and non-life sectors could slow from its 2002 to 2007 levels of 11.4% and 10.6%, respectively, to around 7–10% and 3–8%, respectively, between 2008 and 2013.

Figure 9:
Growth in non-life and life insurance premiums

Life insurance premiums



Non-life insurance premiums

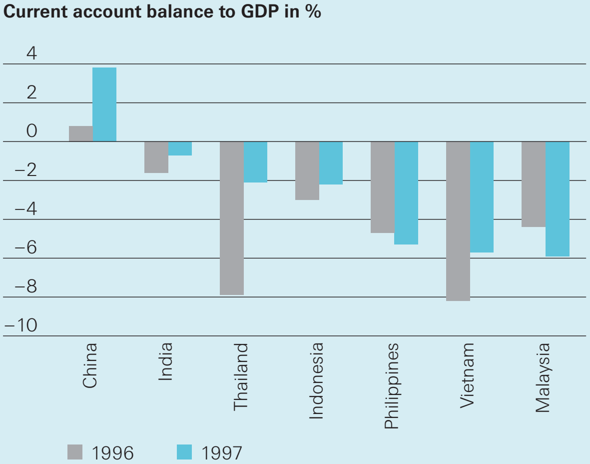


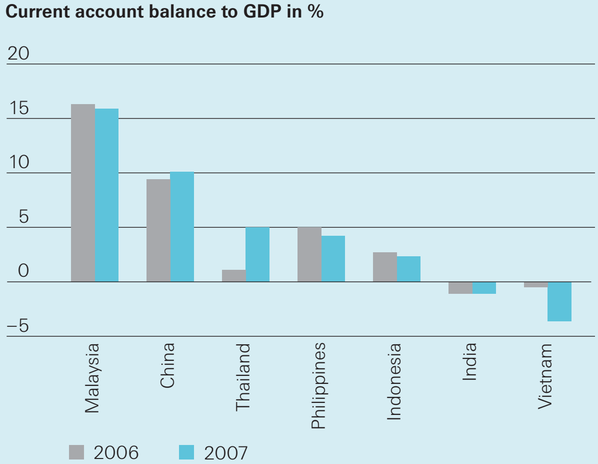
Source: National insurance authorities; Swiss Re Economic Research & Consulting

Another Asian financial crisis?

The sharply deteriorating economic fundamentals in Vietnam have triggered concerns that another Asian financial crisis could occur. Vietnam's current account deficit surged from USD 12.4bn in 2007 to USD 14.8bn during the first six months of 2008. In addition, its CPI inflation soared to 28.3% in August 2008, while its currency depreciated by 30%. This scenario strongly resembles what happened in Thailand ten years ago, and has prompted fears that the Asian financial crisis could indeed reoccur.

Figure 10:
Current account balance 2007/2006 vs. before the Asian crisis (1996/1997)



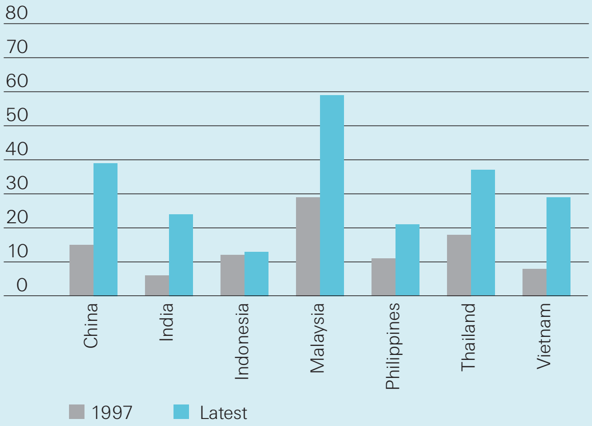


Source: CEIC, Oxford Economic Forecasting; Swiss Re Economic Research & Consulting

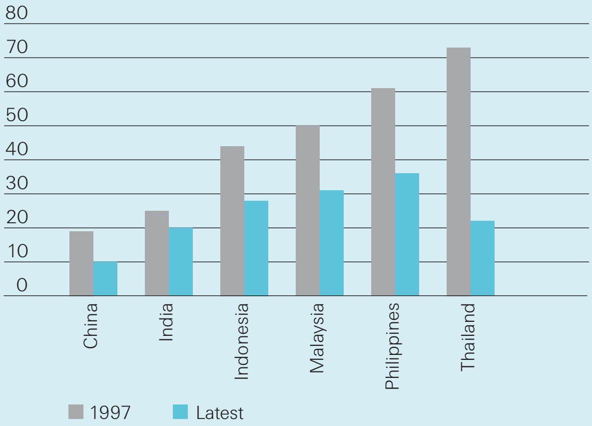
In terms of foreign trade, Asian markets are all performing better than they did 10 years ago. Most of the emerging markets in Asia are also running a current account surplus, unlike a decade ago, when most were running deficits. During this period, to maintain their balance of payments, emerging markets were dependent on the surplus in their capital accounts (capital inflows). This meant their financial stability was highly exposed to the flow of capital and vulnerable to external shocks.

Figure 11:
Foreign exchange reserves in Asian countries 2008 vs. 1997

Foreign exchange reserves as a % of GDP



Foreign debt as a % of GDP

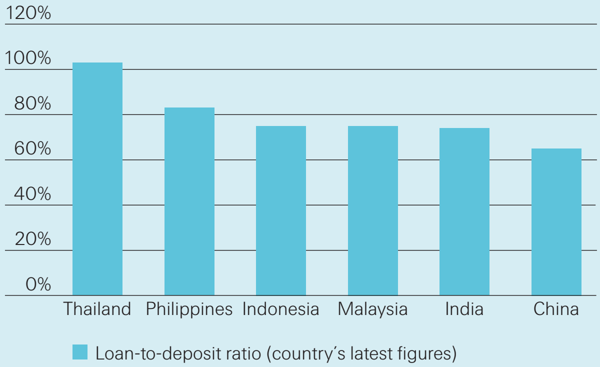


Source: IMF, IIF, Swiss Re Economic Research & Consulting

A decade ago, most Asian countries' ratios of foreign exchange reserves, as a percentage of GDP, were much lower than at present. Once net capital outflows persist, the depreciation of the local currency makes paying back external debt much more difficult, which led to the financial crisis. Most Asian countries have since increased their foreign reserves substantially; China, in particular, now has over USD 1500bn in reserves, which is more than 10 times the amount it had in 1997.

While a renewed Asian financial crisis is unlikely, the financial turmoil is expected to adversely impact growth. The depreciating Asian currencies and tumbling stock markets have triggered concerns of a credit crunch in Asia, as capital is transferred out of the emerging markets. However, most Asian banks' balance sheets remain strong, as they are relatively unaffected by the write-offs on sub-prime related assets.

Figure 12:
Loan-to-deposit ratios of Asian emerging economies



Source: CEIC, Swiss Re Economic Research & Consulting

Liquidity risk, apart from being the result of deteriorating asset quality, also results from a squeeze in money market conditions. Asian banks are not highly exposed to the risk of a liquidity crunch in the wholesale market, given that most of their loan-to-deposit ratios are below 100%.

Why Islamic insurance?

Insurance penetration in Muslim countries is just 1.3%, versus 2.8% in the emerging markets.

Roughly a quarter of the world's population belong to the Islamic faith. Although they live all over the world, many Muslims live in the fast-growing emerging market economies. Insurance penetration, particularly life insurance, is low in Muslim countries[6]. Premiums written amounted to just 1.3% of GDP in 2007, versus 2.8% of GDP in the emerging markets. While economic growth has been solid in most Muslim countries since the turn of the century, the insurance sector has lagged. One reason for the low penetration is that conventional insurance is not compatible with Islamic faith. In order to grow the insurance market in Muslim countries, it is important to understand the different Islamic insurance models along with their unique challenges and opportunities.

Insurance under Islam

Sources of Islamic law

The Quran is the ultimate source of all Islamic principles that were revealed to the prophet Mohammed by Allah, supplemented by the sayings and actions of the Prophet (Sunnah). These two sources are the roots of Islamic belief, which lay out general principles on how a Muslim should lead his/her life, albeit not all aspects of life. Solutions for problems, particularly those arising from changes in the environment, are derived by Islamic jurists (scholars) using processes of individual and collective reasoning that do not contradict the Quran and Sunnah. This is the body of Islamic religious law, commonly referred to as shariah.

Opinions on some aspects of economic transactions are divergent.

The fiqh al-mu'amalat is the sub-arm of Islamic jurisprudence that sets forth the requirements for economic transactions to comply with shariah. Within Islam, the rules are clear on certain issues, eg the charging or receiving of interest (riba) is not permitted. However, there are various judicial opinions (fatwa) on other questions, eg how shariah-compliant insurance is to be conducted. All of these rules are considered important and strengthen the diversity of the Islamic belief system.

Criteria for insurance to be shariah-compliant

Muslims conduct their lives according to the Islamic principles laid out in shariah. Consequently, all transactions must be shariah-compliant, including the type of insurance coverage purchased. The following must be avoided:

- *Riba:* payment/receipt of interest
- *Maisir:* excessive risk taking
- *Gharar:* uncertainty and unclear terms in contracts
- *Haram:* investment in anything unacceptable – eg pork, alcohol, gambling and pornography

In 1985, a council of Islamic scholars declared that conventional insurance was forbidden.

In 1985, the grand council of Islamic scholars (Majama al-Fiqh; Academy of the Organization of Islamic Conference) reached an agreement on insurance:

1. *The commercial insurance contract, as practiced by commercial insurance companies, contains substantial uncertainty, which renders the contract defective. Consequently, it is forbidden.*
2. *The alternative contract, which respects the principles of Islamic transactions, is the cooperative insurance contract. It is built on the principles of voluntary contribution and mutual cooperation. The same applies to reinsurance, which should also be built on the principles of mutual cooperation.*
3. *The academy calls on Islamic countries to establish mutual cooperative institutions for insurance and reinsurance. [...]*

[6] Muslim countries are those with a Muslim population of 50% or more.

The Fiqh Academy of the Muslim League also ruled, with one notable dissension from Professor Mustafa Al-Zarqa (see box below): "Commercial insurance is a form of gambling, since the insured pays a premium and either receives no compensation or one far exceeding what he paid."[7]

Social and mutual insurance are deemed to be acceptable under Islamic law.

However, virtually all scholars agree that two forms of insurance are permissible, as long as the investments are in shariah-compliant assets:

- *Mutual insurance* – because it is based on voluntary contributions and mutual assistance in the interests of righteousness.
- *Social insurance* – because it involves social cooperation and mutual protection without profit motives; due to this, the arguments of uncertainty do not render these types of insurance contract invalid.

Life insurance can be offered in a shariah-compliant way.

It has been argued that life insurance is permissible according to shariah. Scholars now agree that, by modifying certain terms (eg benefits may only be paid to heirs), and excluding some products with embedded guarantees (eg whole life products), life insurance can be shariah-compliant.

The permissible school

Some shariah scholars disagree with the ruling on insurance by the Fiqh Academy, most notably Professor Mustafa Al-Zarqa. He states: "I have found no proof in the texts of the shariah, or its legal theory, that would forbid insurance. On the contrary, I found proof of shariah and its general objectives, to point jointly towards its permissibility and approbation, as a means of eliminating risks and losses."

Shariah arbitrage

According to this school of thought, shariah arbitrage is an issue in the sense that it is possible to forbid some financial transactions, but permit them in a slightly different form, even though the substance is unaltered. This school of thought argues that the objections to excessive uncertainty and risk taking (gharar) do not apply given the common use of insurance in economic life. Gharar only exists if the insurance contract is viewed on the individual level. At the aggregate level, every person knows what he pays and what he receives in exchange. However, the Fiqh Academy rejected these arguments.[8] The school acknowledges the requirements to avoid interest and investments in non-permissible industries.[9]

[7] El-Gamal, Mahmoud A. (2006), *Islamic finance, law, economics, and practice*. New York: Cambridge University Press, p. 147.
[8] El-Gamal, Mahmoud A. (2006), *Islamic finance, law, economics, and practice*. New York: Cambridge University Press, p. 150.
[9] It may be noted that Sunnism and Shiism scholars differ substantially on which canonical traditions and methods are deemed acceptable. The Sunni view is outlined above. However, there is a trend towards convergence (Source: El-Gamal, Mahmoud A. (2006), *Islamic finance, law, economics, and practice*. New York: Cambridge University Press, p. 19).

A wide spectrum of Islamic insurance models

Various interpretations of Islamic law exist.

Given the varying interpretations of Islamic law, different insurance models have emerged. The models considered include non-profit mutual insurance and models that closely resemble conventional insurance, with funds invested in shariah-compliant assets.

Takaful is one form of shariah-compliant insurance that uses segregated funds.

In this *sigma*, a distinction is made between Islamic insurance and takaful. While Islamic insurance refers to all concepts of Islamic insurance, takaful refers specifically to insurance models that use segregated funds for policyholders and shareholders.

Takaful

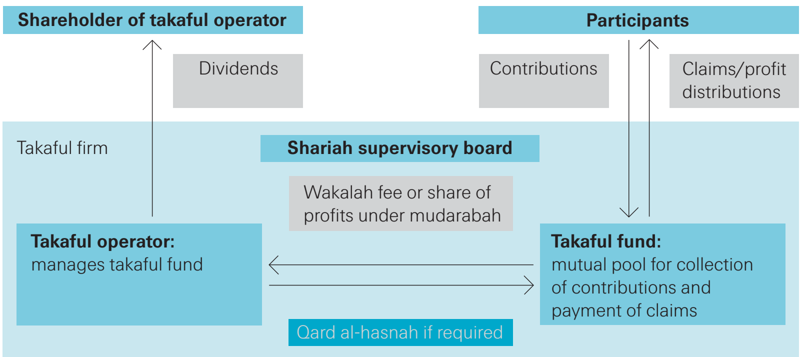
Takaful is based on mutual assistance and voluntary contribution.

Takaful is a system 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 the clear definition of the type of loss, uncertainty (gharar) and excessive risk taking (maisir) are removed from the contract. Takaful has been practised for centuries as a system of risk sharing. Today, various models exist.

The main takaful operation models

Takaful involves:
- The creation of a shariah supervisory board that oversees insurance operations and compliance with the shariah
- The separation of shareholder funds from policyholder funds
- The commitment to distribute technical profits to policyholders
- The avoidance of investment in non-shariah-compliant assets

Figure 13:
Stylised profit-oriented takaful operating model



Source: Fitch, Swiss Re Economic Research & Consulting

Takaful life insurance is called family takaful; the non-life form is generally referred to as takaful.

The takaful operator, typically a stock company, is paid a fixed proportional fee (wakalah fee), a performance-based fee (mudarabah) or a combination of the two. If there is an underwriting deficit, the takaful operator is not allowed to cover it. Instead, it must provide a non-interest bearing loan (qard al-hasnah) that is to be repaid by future surpluses from the underwriting pool. The duration of a takaful contract must also be clarified. The policyholders are the participants in takaful life insurance, also referred to as family takaful.

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

Takaful products are sold by companies set up as fully Islamic firms, where the entire business operations are undertaken in accordance with the shariah. Alternatively, takaful products can be sold by conventional financial institutions through an Islamic window that allows customers to purchase shariah-compliant products and services. Such institutions may also sell conventional products.

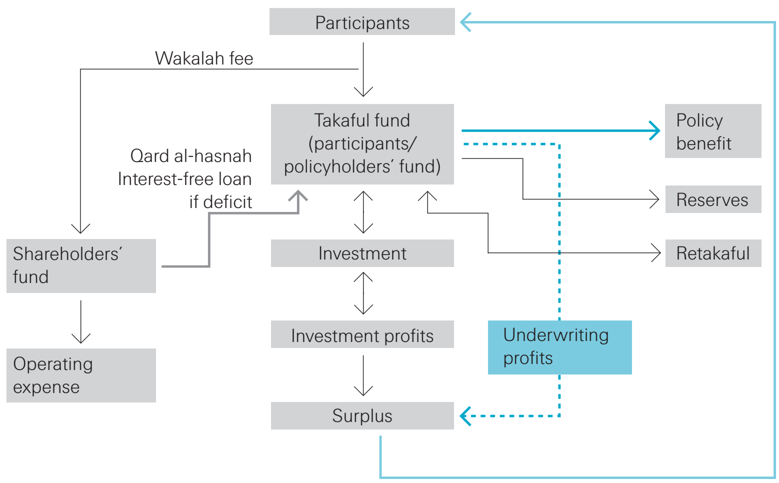
Today, the most popular takaful models are the agency model (wakalah), the profit-sharing model (mudarabah) or a combination of the two (hybrid model). A fourth model (waqf, endowment model) can be found in Pakistan.

Wakalah model

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

Under the wakalah model, insurance companies act as pure operating agents for the participants – ie policyholders. The wakalah model is similar to a mutual fund in that the operating agent receives a set fee – a pre-agreed proportion of the contributions paid by the policyholders – to invest the takaful funds and run the takaful business on their behalf. The operating agent does not receive any of the underwriting 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 al-hasnah) to the takaful fund, to be repaid when the fund has a surplus.

Figure 14:
Wakalah model



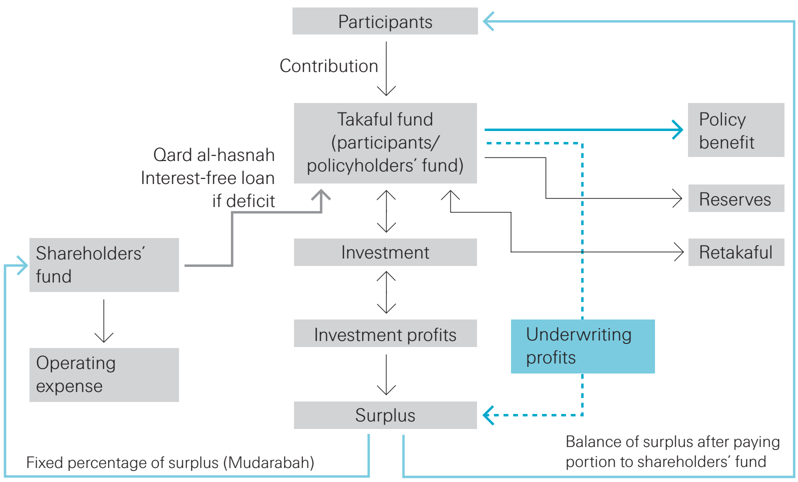
Source: Swiss Re Economic Research & Consulting

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.

Figure 15:
Mudarabah model



Source: Swiss Re Economic Research & Consulting

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 fixed proportional share of the contributions paid by policyholders plus a share of the profits earned on investment activities. Some financial regulators and international organisations (eg Accounting and Auditing Organisation for Islamic Financial Institutions, AAOIFI) recommend the hybrid model because it leverages the strengths of the wakalah and mudarabah models. Applying the mudarabah model to investment activities helps mitigate principal-agent problems, whereas the use of the wakalah model allows the operator to recover the administrative costs of underwriting.

Waqf model

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

Under the waqf model, the operating agent makes an initial contribution to a waqf fund. Policyholders make additional contributions to the fund, which is then used to settle claims. The operating agent earns a fixed underwriting fee (wakalah fee). Policyholders receive any funds left in the pool after all claims are paid. Due to the fixed fee, the model is also called the wakalah waqf model.

Conclusions on models

Implementation of models vary, due to different interpretations by shariah supervisory boards.

The models shown above have been stylised to illustrate basic similarities and differences. Because the ultimate responsibility for shariah compliance lies with each company's shariah supervisory board, takaful models are implemented slightly differently depending on the market and the company. For example, in Malaysia, a modified mudarabah model exists where the operating agent charges a fixed fee to cover the administrative cost of underwriting and distribution. In addition, the operator receives a share of the profits from the takaful pool.[10]

Wakalah offers the advantage of predictable revenues for the operator.

One of the advantages of the wakalah model is that when starting a new fund, operators know how much revenue they will generate because they receive a fixed share of the contributions. The advantage of the mudarabah model is that operators have a bigger incentive to engage in efficient underwriting and strategically invest, as they will receive a portion of the surplus. Under both models, the operator is not allowed to cover losses, but may have to provide a voluntary loan (qard al-hasnah) to temporarily finance the deficit, which creates an incentive to be stringent in underwriting.

Technical aspects of running a takaful company are very similar to those of a conventional insurer.

In terms of the technical aspects of the business, running a takaful company is very similar to running a conventional insurance company. The main difference is the segregation of shareholder and policyholder funds under the takaful model, although a segregation of funds is also required in some countries for certain lines of business (eg Germany). Another key difference is strict adherence to shariah in their operations.

Takaful, a hybrid of mutual and stock companies

Most takaful operations today are profit-oriented stock companies with mutuality applying to the takaful pool.

On the surface, takaful appears to be similar to the conventional mutual insurer concept. Upon closer inspection, however, the vast majority of takaful companies today operate as 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 (ie 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 behave as stock companies in that they use capital to cover their liabilities.

Non-profit takaful companies are very similar to traditional mutuals.

Takaful companies that are not profit-oriented are almost identical to mutual companies. The key difference is that takaful companies must have a shariah supervisory board, cannot earn or charge interest on loans and must avoid investing in non-shariah-compliant industries.

[10] Source: Kassim, Zainal Abidin Mohd (2007). Takaful, a Question of Surplus. In *Islamic Insurance: Trends Opportunities and the Future of Takaful.* London: Euromoney.

Alignment of interests between management and customers in profit-oriented takaful companies

It has been shown that mutuals are better than stock insurance companies at addressing agency conflicts between owners and customers.[11] In the predominantly hybrid takaful companies today, the distribution of the functions of manager, owner and customer fall between those of mutuals and stock insurance companies (see Figure 16). Like mutuals, the conflicts of interest between owners and customers at a profit-oriented takaful company should be mitigated because the functions overlap and both benefit when profits rise. However, managers of takaful companies – like those of stock insurance companies – are still exposed to market pressure, which creates an incentive to manage the company efficiently.

Figure 16:
Comparing stock insurance, takaful and mutual companies

	Manager	Owner	Customer	Oversight
Profit-oriented takaful	Manager	Stockholder (stockholder fund); Participant (takaful fund)	Participant	Board of directors/ shariah board
Stock insurance company	Manager	Stockholder	Policyholder	Board of directors
Mutuals/non-profit takaful	Manager	Policyholder/Participant	Policyholder/Participant	Supervisory board/ shariah board

Sources: Smith, Clifford W. (1986). On the Convergence of Insurance and Finance Research. *Journal of Risk and Insurance,* vol. 53, p. 693-717, Swiss Re Economic Research & Consulting

Market overview of Muslim countries

The Islamic insurance market

Since 1979, the number of takaful operators has grown to 100–150.

The Islamic Insurance Company of Sudan, licensed in 1979, was the first takaful company in modern history. By 1985, takaful companies had been set up in the United Arab Emirates, Malaysia, and Bahrain.[12] Today, depending on the source, 100–150 companies or takaful windows exist.

Total takaful contributions amounted to USD 1.7bn in 2007.

Approximately USD 1.7bn in takaful premiums were written in 2007. Estimates of the size of the market range from USD 1bn to USD 5.6bn, depending on how takaful is defined.[13] While the exact size of the takaful market is disputed, its rapid growth is not.

In 2007, takaful premiums in the emerging markets grew by roughly 26% and accounted for 5% of insurance premiums written in Muslim countries. Figure 17 depicts the different segments of Islamic insurance:
- Profit-oriented and non-profit takaful (USD 1.7bn): eg premiums written under the models with segregated funds, as described above.
- Cooperative models (USD 0.5bn): as prescribed by the Saudi Arabia Regulator (see section on Saudi Arabia below).
- Conventional insurance companies within an Islamic financial system (USD 3.5bn): eg Iranian companies operating on a conventional basis with investments in shariah-compliant assets.

[11] Swiss Re *sigma* No 4/1999, "Are mutuals an endangered species?"
[12] Kwon, Jean W. (2007). Islamic principle and Takaful: Re-evaluation. *Journal of Insurance Regulation,* Vol. 26 (1), p. 53–82.
[13] World Insurance Directory, S&P

Available data on the takaful industry is improving gradually.

Although the availability of data on the takaful industry has improved significantly in recent years, it could still be improved further. Market estimates differ because of the varying definitions of takaful and because some (re)takaful companies also write conventional business, making it difficult to quantify the amount of "pure" takaful contributions. The figures in this *sigma* are best estimates that take into account all available sources – eg supervisory authorities, the World Islamic Insurance Directory and company data. The goal is to identify the share of contributions at takaful companies using models that segregate policyholder and shareholder funds.

Figure 17:
Models of Islamic insurance used in Muslim countries and market size 2007. (Premiums/contributions USD m)

	Insurance in Muslim countries (USD 45 014m)				
	Islamic insurance (USD 5 643m)				Conventional
	Takaful (USD 1659m)				
Company set-up	non-profit	profit-oriented	Cooperative ta'awuni model	Conventional within Islamic financial system	Conventional
Bahrain		42			319
Indonesia		104			6 834
Iran				3 505	
Malaysia		526			8 943
Saudi Arabia		430	479		1 382
Sudan	232				41
UAE		83			3 890
Other countries+		241			17 962
Total	232	1 426	479	3 505	39 371

+ other Muslim countries
Source: National insurance authorities, World Insurance Directory, Swiss Re Economic Research & Consulting estimates.

Five major markets

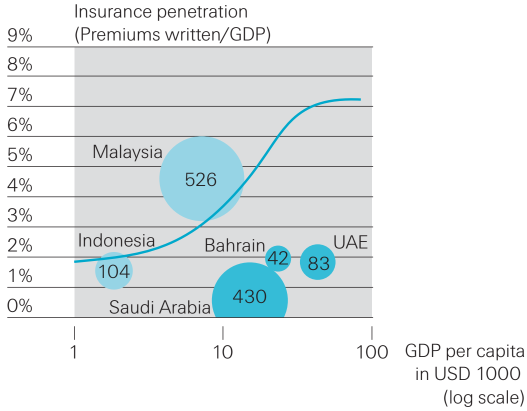
Five major markets act as role models.

The following takaful markets were chosen because they represent best practice and/or reflect the challenges and opportunities for takaful in the emerging markets:

- *Malaysia* – the most developed takaful market with advanced regulations that encourage takaful growth; acts as a hub for Islamic finance
- *Indonesia* – has the largest Muslim population globally, low per-capita income and low insurance penetration; also has a small but growing takaful industry with many small companies
- *Saudi Arabia* – the largest Middle East economy, has a rapidly growing takaful industry and an untapped life insurance market
- *United Arab Emirates (UAE)* – the most developed and largest conventional insurance market in the Middle East with a very dynamic economy
- *Bahrain* – has a very small insurance market, an advanced regulatory framework and is an emerging hub for Islamic finance in the Middle East

These five countries provide a good overview of takaful markets today, both in terms of market development and the regulatory environment. The two Asian markets show total insurance penetration at levels that more or less reflect their wealth (blue line in Figure 18: the S-Curve[14]). Malaysia is above and Indonesia is just below the expected levels of penetration based on GDP per capita. While life insurance penetration in Malaysia and Indonesia is high, the opposite is true in the Middle East. The large share of the oil sector, with its elevated prices, could distort the reality. Even when oil GDP is excluded, penetration is still remarkably low in the Middle East.

Figure 18:
Total insurance penetration and GDP per capita in 2007. Line indicates expected insurance penetration at a given income level. Size of bubble indicates total takaful premiums written (USD m).



Sources: World Insurance Directory, Swiss Re Economic Research & Consulting estimates

[14] For more information on the definition, methodology and interpretation of the S-curve, refer to Swiss Re *sigma* No 5/1999, "Asia's insurance markets after the storm", and Enz, Rudolf (2000). The S-Curve Relation between Per-Capita Income and Insurance Penetration. In *The Geneva Papers on Risk and Insurance, Issues and Practice,* Vol. 25, No 3.

Malaysia

Malaysia

	2007
Population, m	26.6
GDP, USD bn	191.7
GDP per capita USD 1 000	7.2
Average real GDP growth (04–07)	5.5%

Overview

Within the Southeast Asia region, Malaysia is the third-largest economy and Asia's largest net exporter of natural gas and oil. In the short to medium term, under the Ninth Malaysia Plan (2006–2010), the country will continue to open its banking and insurance sectors to permit greater competition. The government has also been proactive in promoting Malaysia as an international Islamic financial hub. Tax incentives[15] were proposed for takaful operators in the 2008 national budget. Concerns about the lack of progress in many liberalisation initiatives have increased. Also, the heightened political instability poses risks to the generally positive outlook.

Malaysia has put incentives in place to develop the takaful market.

Regulatory framework

Malaysia is aiming to become an international Islamic financial hub, as laid out in the 2001 financial sector master plan. Takaful is an important component of this plan. Malaysia's insurance sector falls under the jurisdiction of the Bank Negara Malaysia (BNM), the central bank of Malaysia. Unlike Bahrain or the Dubai International Financial Center, the Shariah Advisory Council of the BNM is responsible for advising on matters related to takaful businesses and other areas of Islamic finance that are supervised and regulated by the central bank. The council consists of shariah scholars, jurists and market practitioners. They issue shariah resolutions (fatwa) and decisions relating to relevant jurisdictions, such as the authenticity of shariah-compliant products.

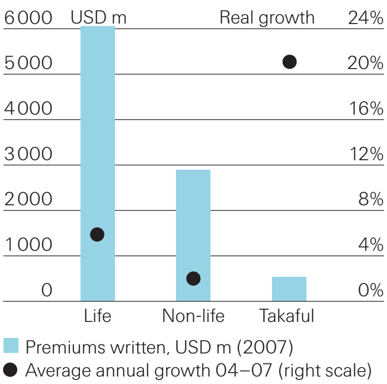
Lower entry barrier for takaful companies

To encourage development, the barriers to entry for takaful companies in Malaysia are lower than for conventional insurance. The paid-up capital for takaful companies/branches is also just one-tenth of what conventional insurance market players must maintain. Moreover, the Malaysian government offers[16] favourable tax incentives to new takaful operators.

Approval of shariah compliance by government

The Director-General of Takaful, the BNM Governor, has to be satisfied that the company is shariah-compliant. While a takaful company must establish its own shariah board, the regulator, however, does not require the use of a specific takaful model.

Malaysia: Insurance and takaful market



Market

In 2007, premiums written in Malaysia – including takaful business – were estimated at USD 9.2bn. Over the last three years, the conventional life market, which accounts for two-thirds of the total market, has experienced strong growth. Due to the robust sales of investment-linked products, premium volume expanded by 5.9% (adjusted for inflation) in 2007, above the three-year average of 4.3%. Growth in the non-life sector was 2% in 2007; the sector was significantly affected by fierce price competition in the largest business lines – ie motor (44.5% market share) and property (18%).

[15] Management expenses and profits distributed from family and general takaful funds can be claimed as tax deductions under the proposal.
[16] See footnote 15.

While life insurance dominates in the conventional market, the size of non-life and family (life) takaful are fairly equal[17]; total takaful premiums in 2007 were estimated at 5.8% of the total market. The small size of the market suggests that takaful is in the early stages of development, and has significant potential to grow. Because the base is so small, growth has been quite fast – about 21% per year (adjusted for inflation) over the past three years. When looking back further, takaful premiums written have expanded at an annual average rate of 17% between 1998 and 2007.

Net claims incurred ratio (2007)

	conventional	takaful
Overall	65.7%	71.5%
Motor	80.9%	65.0%
Fire	44.6%	96.3%
MAT	54.4%	281.5%

Source: Insurance Services Malaysia Berhad

Similar to the conventional market, takaful operators in Malaysia offer all lines of insurance. For non-life takaful, figures as of 2007[18] showed that motor (48.4%) and fire (27.8%) were the most popular lines in the sector, which is very similar to the spending pattern observed in the conventional market. It is worth noting that a temporary plan (ie term policy) remained dominant in Malaysia family takaful; mortgage financing drove almost 90% of the sales. According to estimates, the takaful market is set to continue growing well into the future.

Takaful models used

Free choice of model possible; pure mudarabah losing ground

As mentioned above, regulations do not restrict the choice of a takaful model. The mudarabah model was initially the model of choice in the Malaysian market, although today it is losing ground to wakalah. Only two of the original operators are still using the mudarabah model.

Insurance awareness is high in Malaysia.

The awareness of insurance products is fairly high in Malaysia, compared to other emerging markets in Asia and the Middle East. It is generally believed that Malaysians buy takaful products for religious reasons and because the surplus in the pool is returned to policyholders. Some market practitioners suggest that takaful products attract non-Muslim buyers as well.

Distribution channels

Direct marketing is still dominant but gradually losing ground; bancatakaful looks promising.

Although its importance is diminishing, direct marketing plays a key role in the Malaysian takaful industry. However, most takaful operators continue to sell through the existing branches of their financial institutions. Therefore, bancatakaful (shariah-compliant bancassurance) is likely to remain an important distribution channel (20% of sales in 2005). However, the share of sales through agents and brokers who sell face to face will grow because it presents the best opportunity for sellers to educate consumers about takaful products.

[17] Only annual premium figures released from official sources; the family takaful premiums are therefore underestimated.
[18] Figures from Bank Negara Malaysia.

Indonesia

Indonesia

	2007
Population, m	231.6
GDP, USD bn	433.3
GDP per capita USD 1000	1.9
Average real GDP growth (04–07)	5.7%

Overview

The Indonesian economy has grown steadily over the last three years (+6% per year, adjusted for inflation), driven mainly by strong domestic demand and robust oil and gas exports. While falling oil prices have had a negative impact on revenues from oil exports, they have allowed the government to increase development spending as oil subsidies fell. Inflationary pressure remains high, although it is expected to lessen due to the drop in fuel prices.

Regulatory framework

No special incentives for takaful companies

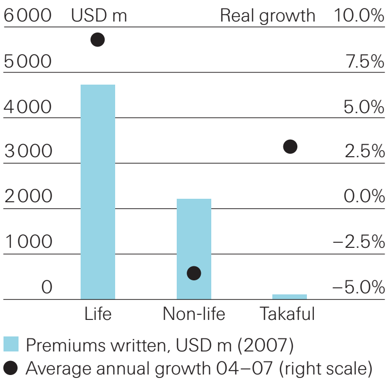
Insurers in Indonesia must operate as: 1) state-owned companies, 2) limited liability companies or 3) co-operatives. Takaful or shariah-compliant companies are classified as "co-operatives". The Indonesian government has remained neutral on the development of takaful business and has not created any special incentives for takaful operators. Like conventional insurance companies, takaful operators must comply with the current Risk-Based Capital regime.

Conventional insurers can also offer takaful products.

Due to the absence of a local shariah system, Indonesian shariah-compliant products are based on either the Malaysian or Bahraini models. It is also worth noting that conventional insurers are permitted to sell takaful products through a shariah-compliant insurance department, although business accounting has to separate shariah-compliant business from conventional insurance. In addition, takaful operators must have at least one board member who is capable of ensuring the authenticity of shariah-compliant products.

Market

Indonesia:
Insurance and takaful market



The Indonesian insurance market is relatively small despite its large population. Total conventional premium written in Indonesia amounted to about USD 6.9bn in 2007. Life business, which accounted for 64% of the overall market, has experienced almost double-digit real growth over the last three years due to the solid growth of investment-linked products. The non-life sector's results were less stellar during the same period, as the fire and motor businesses, the two biggest non-life lines, were negatively impacted by price competition and cuts in fuel subsidies.

The Indonesian insurance market is highly fragmented, with more than 100 insurers. In early 2008, takaful products were sold by three pure takaful operators and 32 insurers in Indonesia. The takaful market has doubled in size from USD 56m in 2006 to approximately USD 150m[19] in 2007. With the increasing awareness and acceptance of takaful products, the overall market is expected to expand to USD 1.2bn by 2015.

[19] Figures from Shariah Insurance Association of Indonesia (AASI).

Takaful models used

Various models co-exist.

It is unclear if wakalah or mudarabah is the generally accepted model in Indonesia. Although different models can be applied to various products, operators often choose just one model to minimise operational costs. Takaful products, first launched in the mid-1990s, are relatively new to Indonesia. As a result, takaful operators generally prefer simple products based on one model, which their clients can easily understand.

Distribution channels

Brokers and agents are the preferred distribution channel.

Brokers and agents are the preferred distribution channels in Indo-nesia, although bancatakaful is increasing in importance. Due to the relatively low awareness of insurance, brokers and agents are particularly important as they provide more direct and interactive services for corporate clients and rural customers. Bancatakaful is popular with individual clients and is an established channel for standardised family takaful products.

Saudi Arabia

Saudi Arabia

	2007
Population, m	24.7
GDP, USD bn	376.3
GDP per capita USD 1000	15.2
Average real GDP growth (04–07)	4.6%

Overview

Economic growth in Saudi Arabia has been solid over the past three years (+4.6% per year, adjusted for inflation). The non-oil sector – the driving force – has been fuelled by rising revenues from high oil prices. Large infrastructure projects have been planned in an attempt to diversify the economy. The government hopes to encourage the growth of non-oil industries and improve education and skills by creating economic and knowledge cities. Saudi Arabia hosts a large expatriate workforce, although most hold low-skilled jobs. The economic outlook remains favourable, though oil prices have tumbled from their record highs in mid-2008.

Regulatory framework

The Saudi Arabian law system is based on shariah. Only after the ruling of the Fiqh Academy in 1985 did religious scholars allow cooperative insurance to be sold. This led to the establishment of the National Company for Cooperative Insurance (NCCI) in 1986.[20] Article 1 of the law on supervision of Cooperative Insurance, passed in 1999, requires companies to be established in a cooperative manner (called the ta'awuni model). To obtain a license, a company must:

- be established as a joint stock company
- return surpluses from insurance operations to shareholders and 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

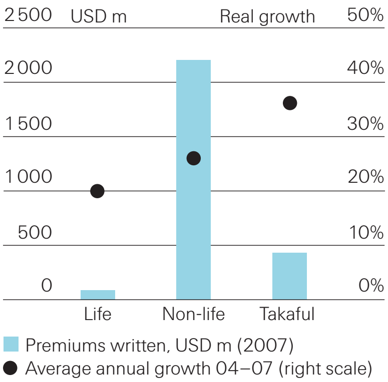
Due to new regulations, the licensing process is ongoing.

Existing insurance companies had to apply for a licence in order to continue operating in the market. However, during the transition period that ended in early 2008, unlicensed companies were still allowed to write business. Saudi Arabia does not explicitly require the use of takaful models, unlike Bahrain and Malaysia, which have regulations in place that do require their use.[21]

Market

The Saudi Arabian market is in transition. The licensing process, initiated by the law on cooperative insurance, is ongoing. To date, 14 of the 35 companies that applied have been granted a licence. Half of those with a licence have set up takaful operations, using one of the models described earlier, or, at the very least, offer some takaful products.

Saudi Arabia:
Insurance and takaful market



In 2007, premiums written in Saudi Arabia amounted to USD 2 291m. Takaful accounted for approximately 20% of the market. Life insurance accounted for just 4% (USD 87m). The insurance sector has expanded rapidly over the past three years, driven by the strong economic growth and the introduction of compulsory lines in recent years (eg motor, health and medical malpractice). Health, which represented 37% of the non-life premiums written, has surpassed motor (30%) as the largest business line in non-life; property (9%) is the third largest line.

[20] Tawuniya, the former NCCI, has, as of 2005, explicitly marketed takaful products and set up a shariah board.

[21] Wilson, Rodney (2007). Concerns and Misconceptions in the Provision of Takaful. In *Islamic Insurance: Trends Opportunities and the Future of Takaful*, London: Euromoney.

Takaful companies are focusing on personal lines.

Takaful companies offer all lines of business, although market information on the premium volumes for individual lines is unavailable. Nevertheless, the personal lines of business (mainly motor) are considered to be the most popular. According to company data, family takaful, which is offered to both groups and individuals, has experienced solid growth. Family takaful products are mostly combined protection savings products for individuals related to a specific life event (eg education, wedding). Bank Aljazira's Takaful Ta'awuni Division and SABB Takaful (subsidiary of HSBC) are the market leaders. Group business is also targeted, although price competition is fierce.

Insurance awareness is rather low.

Consumer awareness of insurance is low, and many people still consider any kind of insurance to be incompatible with shariah, particularly life insurance. Marketing by takaful companies is expected to play an important role in raising the public's awareness of insurance and reducing their aversion to it. Takaful business is expected to continue to rise in importance, particularly personal business lines. Growth should be strong over the next few years, led by the health and motor businesses. Takaful operators are well positioned to capture a significant share of the individual life business. By 2015, the Saudi takaful market could exceed USD 2bn and account for more than a quarter of the insurance sector.

Takaful models used

Various models are used; the hybrid model is popular.

As long as the regulatory requirements to offer cooperative insurance are met, companies have some latitude in implementing takaful models. However, many takaful operators have adopted the hybrid model, using wakalah for underwriting and mudarabah for investment activities, particularly in life insurance.

Distribution channels

Agents and brokers may give way to bancatakaful in the future.

Because a substantial part of business is sourced from the shareholders of an insurance company, direct sales dominate in Saudi Arabia. Tawuniya, formerly a monopoly, is employing a multi-channel distribution strategy by using branches and agents. The distribution channels for takaful products are not expected to change. In order to demonstrate to customers that insurance is shariah-compliant, takaful operators need a well-educated sales force that can explain the products. This seems to favour a tied-agent approach. Bancassurance is an option, although it is more successful when products are very simple.

United Arab Emirates

United Arab Emirates

	2007
Population, m	4.4
GDP, USD bn	190.0
GDP per capita USD 1000	43.4
Average real GDP growth (04–07)	8.4%

Overview

The United Arab Emirates (UAE) is a federation of seven independent states. Abu Dhabi is the largest of the emirates and the federation's main oil producer, while Dubai is the most known. The economy has been very strong over the past four years, growing at an average annual rate of 8.4% in real terms. The non-oil sector has been driving growth, and its large-scale infrastructure projects have been financed by high oil revenues. Economic growth is expected to remain solid in the future, given the number of large construction projects planned. After peaking in 2008, inflation is expected to ease gradually.

Regulatory framework

Two distinct regulations: the less regulated domestic market and the highly regulated offshore Dubai Financial Center

The UAE has a dual law system; shariah courts are responsible for family and religious affairs. Insurance regulations are currently being reformed. Under Federal Law 6 of 2007, which states that a new insurance commission will be created, some standards have been set, although many issues remain unresolved. The new law, for example, allows for the establishment of conventional and takaful companies, but no further requirements for the operation of takaful companies have been decided.

Specific rules exist for takaful operators in the Dubai International Financial Center.

Established in 2007 as an offshore financial centre, the Dubai International Financial Service Center (DIFC) has a distinct supervisor and regulator who encourage the development of takaful. DIFC regulator applies advanced regulatory standards, such as risk-based capital and solvency requirements. Takaful companies operating in the DIFC are subject to the same regulations as conventional insurers (eg Prudential Insurance Rulebook), but must also fulfil the requirements set forth in the Islamic Financial Services Rulebook (IFS). The IFS prescribes the processes and systems to be put in place, but does not explain how to be shariah-compliant.

The shariah system is required for takaful operators.

The main requirements for offering takaful products are: (1) the specification of the products and contracts, (2) the appointment of a shariah supervisory board, (3) the implementation of processes on how to achieve shariah compliance, (4) the establishment of shariah-related risk management practices and (5) the adoption of accounting and auditing standards set forth by the AAOIFI.[22]

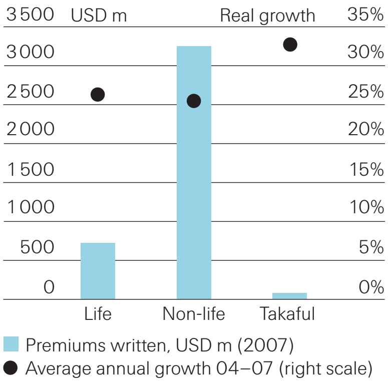
Market

The UAE has a relatively advanced conventional insurance market, but the takaful sector is small.

With premiums of USD 3 974m (2007), the insurance market in the UAE is the largest and most advanced insurance market in the Middle East. Premiums grew by an exceptional 28% in 2007 (adjusted for inflation), exceeding the three-year average of 25%. The booming construction sector boosted the growth of engineering and property insurance. Health insurance has benefited from a 2006 Abu Dhabi law that requires employers to provide coverage for employees. Compared to other countries, life insurance penetration is low in the UAE. Nevertheless, life insurance premiums jumped 44% in 2007. Motor is the largest business line (35% in 2006), followed by property (17%), marine and transport (16%) and the rapidly growing health insurance business (14%).

[22] Accounting and Audititing Organization for Islamic Financial Institutions.

United Arab Emirates: Insurance and takaful market



Takaful accounts for an estimated 2% of the total insurance market in the UAE. This figure is based on company data and data from other sources, which is, at times, inconsistent. Nevertheless, takaful growth is estimated to have exceeded the insurance market's overall growth.

Insurers in the UAE tend to focus on commercial business. Takaful companies, however, focus more on personal business lines, particularly motor and family takaful. The major takaful companies active in the UAE are SALAMA, Abu Dhabi National Takaful and Aman. SALAMA is part of a group that is active across the Middle East, with subsidiaries selling both takaful and retakaful solutions. Some companies offering takaful also sell conventional insurance to achieve a certain scale in the market. Moreover, takaful operators are increasingly targeting the commercial market, but price competition is fierce. Homeowner property insurance, often packaged with mortgages, is uncommon, but growing in popularity. Furthermore, global insurers have been active in the market and a number of them have active takaful subsidiaries.

Solid growth is expected to continue.

In the near term, growth in the UAE insurance sector is expected to remain very solid for takaful and conventional insurance. Health insurance, property and engineering are expected to lead the market. With more takaful companies starting up and others set to enter the takaful market, premiums could reach USD 610m by 2015; this represents an average annual growth rate of 21% (adjusted for inflation). Takaful would still be relatively small – just 4.5% of the entire insurance market (USD 13.7bn). In the longer term, the small population size will limit the potential for growth, particularly when compared to the two Asian countries mentioned earlier.

Takaful models used

Aman uses the wakalah model for underwriting and the mudarabah model for investments. For the rest of the market, it is unclear which models are used and how much business is written on a conventional basis by takaful companies.

Distribution channels

Direct ties between shareholders, sponsors and companies dominate distribution.

Distribution methods vary by location in the UAE. For commercial business, direct placement is the most common method, due to the direct ties between insurance companies and their shareholders/sponsors. Brokers are used for large projects. Bancassurance is gaining momentum in the personal lines – this is also the case for takaful.

Bahrain

Bahrain

	2007
Population, m	0.8
GDP, USD bn	17.5
GDP per capita USD 1000	23.3
Average real GDP growth (04–07)	6.9%

Overview
Bahrain has the smallest economy in the Persian Gulf. It is also the least dependent on oil revenues (25% of GDP), although it uses revenues from oil and gas to diversify into other areas. The economy has expanded solidly over the past three years, with real GDP growing at an average annual rate of 7%. The main driving force has been the booming financial sector, which accounts for 27% of economic output. In the coming years, Bahrain's economy is expected to continue growing, albeit at a slightly slower pace. The energy sector should generate solid revenues, resulting in a current account surplus.

Advanced regulatory framework for takaful

Regulatory framework
The offshore financial centres in Bahrain, Qatar and Dubai are in fierce competition to become the leading financial services hub in the Middle East. Bahrain aims to be the leader in takaful and Islamic finance. The Central Bank of Bahrain (CBB) is the regulator of Bahrain's insurance market. Some observers consider its regulatory framework for takaful to be the best in the Middle East.[23] In contrast to the Dubai International Financial Center, Bahrain explicitly encourages takaful operators to use the hybrid model – ie wakalah for underwriting and mudarabah for investments – to foster a common understanding of takaful.[24]

No special incentives for takaful companies

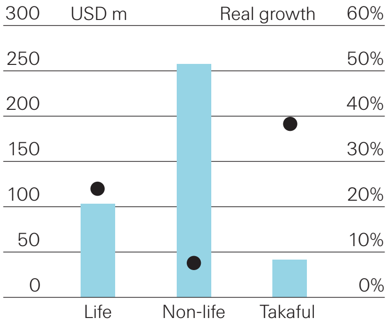
Unlike in Malaysia, Bahraini regulations do not favour takaful over conventional insurance, thereby creating a level playing field. In terms of capital adequacy, each takaful operator must maintain and calculate its solvency requirements as if it were a separately licensed insurance firm, ie applying a risk factor to each of its businesses. For each takaful fund and business category, the takaful operator must maintain separate accounts that meet the standards of the Accounting and Auditing Organization for Islamic and Financial Institutions (AAOIFIC).

Takaful companies have to specify profit-sharing mechanism; there is no centralised checking of products by shariah boards.

Each operator must also establish a policy for the distribution of fund surpluses, although surpluses may only be distributed to policyholders once the minimum solvency requirements are met. In addition, operators must provide loans to the takaful fund to meet solvency requirements. The Central Bank of Bahrain does not check products to determine if they are shariah-compliant. Finally, takaful operators must provide full disclosure of their wakalah fees and mudarabah profit share rates.

[23] Dingwall, Susan, Ali, Shatha and Griffiths, Ffion (2007). Regulatory Approaches to Takaful. Wilson, Rodney (2007). Concerns and Misconceptions in the Provision of Takaful. Both in *Islamic Insurance: Trends Opportunities and the Future of Takaful,* London: Euromoney.
[24] Central Bank of Bahrain (2007). *Insurance Rulebook, TA Takaful/Retakaful,* Manama.

Bahrain:
Insurance and takaful market



Premiums written, USD m (2007)
Average annual growth 04–07 (right scale)

Market

According to preliminary data, total premiums written in Bahrain were USD 361m in 2007. Premiums have grown solidly over the past three years at an average annual rate of approximately 10% (adjusted for inflation). Life insurance, as well as fire and motor insurance, have been the main drivers. The share of life insurance is relatively high at 21% and continues to grow. Motor is the largest business line in non-life. Of the roughly 70 companies and branches established in Bahrain, only 38 may underwrite business outside the country.

According to the central bank, USD 42m in takaful premiums were written in 2007, with premium volume having expanded by 50% over the past three years (adjusted for inflation). Motor is the largest business line in takaful with a 35% market share, followed by health (21%) and property (14%). Family takaful accounts for 8% of the market, significantly less than conventional insurance (31%), although it is also expanding rapidly. 19 companies (18 takaful, 1 retakaful) are currently licensed in Bahrain, including many international players.

The solid development of the insurance sector is likely to continue.

The insurance sector is set to grow solidly in the coming years. Takaful is also expected to grow, given the favourable regulatory environment and the number of companies in Bahrain. Takaful could grow to USD 200m by 2015, which represents an average annual growth rate of 16%. It could potentially account for 30% of the total insurance market, given the rising popularity of family takaful products.

Takaful models used

The hybrid model is required.

According to the central bank's Insurance Rulebook, takaful companies must operate using the hybrid model, ie wakalah for underwriting and mudarabah for investments.

Distribution channels

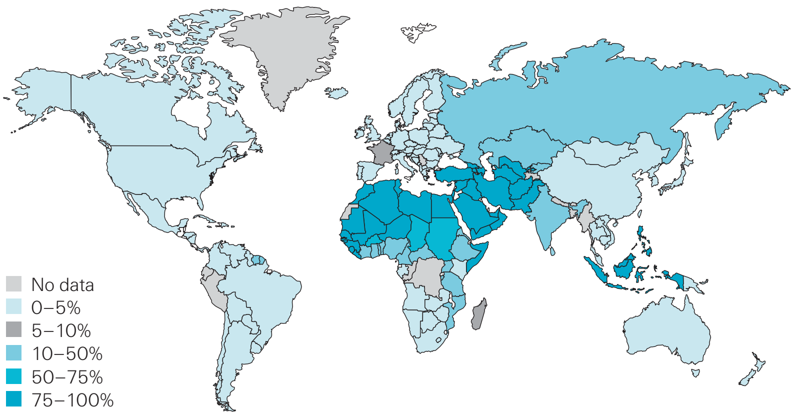
Brokers play an important role; bancassurance could grow in importance.

No reliable data is available, but the use of brokers is common for large industrial risks. Most business, however, is written directly. While bancassurance is rarely used for conventional business, bancatakaful is gaining ground and is considered to be an important channel for the industry.

Market potential and outlook

The Muslim population and the market potential for takaful
One out of every four individuals around the world – ie 1.5 billion people – belong to the Islamic faith. Roughly 22 million Muslims alone live in the industrialised countries. Assuming that every Muslim spends the average insurance outlay of each country, potential takaful premiums would be USD 56bn in 2007.[25]

Figure 19:
Share of Muslim population (2005/2006)



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

Most Muslims live in the Middle East, North Africa and South and East Asia.

The Muslim population is primarily concentrated in the Middle East, Northern Africa and South and East Asia. About 300 million Muslims live as minorities in other countries, with the largest number of Muslims living in India (157m; 13%), China (40m; 3%) and Ethiopia (40m; 48%). Given their fast-growing economies and insurance sectors, India and China are potential markets for Islamic insurance.

Muslim countries have insurance penetrations below the emerging market average.

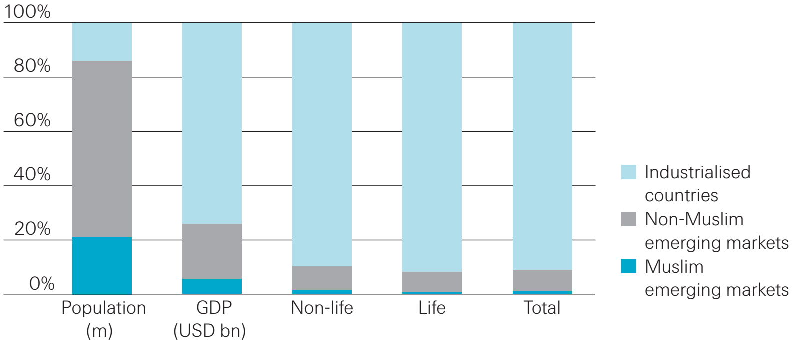
Muslim countries accounted for USD 3 462bn (22%) of emerging market GDP (see Figure 20) in 2007. This is equivalent to an average GDP per capita of USD 2 600, which is only slightly below the average GDP per capita for emerging countries (USD 2 700). In 2007, 11% of emerging market insurance premiums were written in Muslim countries (USD 45bn), indicating a low level of insurance penetration, compared to that of the emerging markets.

Potential takaful market 2007: USD 35–45bn

In 2007, the potential market for takaful in Muslim countries was estimated at USD 35–45bn. The figure will be closer to USD 35bn if only Muslims switch to takaful.[26]

[25] Making the same calculation for the industrialised countries yields another USD 87bn of potential takaful premiums.
[26] This assumes a homogenous distribution of insurance buyers across the whole population and that all Muslims will switch to takaful, which may not be the case.

Figure 20:
Population, GDP and insurance premiums in the industrialised countries and in Muslim and non-Muslim emerging market countries, 2007.



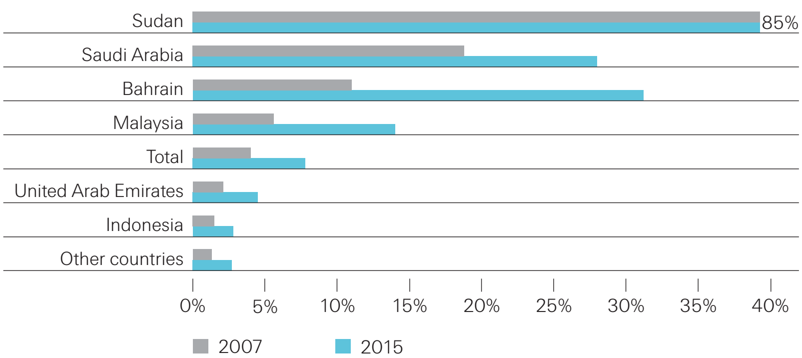
Sources: Swiss Re Economic Research & Consulting, US State Department, CIA world fact book

Past growth and outlook for takaful

Takaful continues to grow and is set to outpace growth in conventional insurance in the long term.

Since its foundation, takaful has continued to prosper. Growth and general awareness have improved since 2000 as interest in Islamic finance increased. In 2007, takaful premiums were estimated at USD 1.7bn. Growth has been exceptional over the past four years – at 26% (adjusted for inflation). Takaful has outpaced growth in the conventional markets by 11%. Growth will be solid in the long term, given the positive economic outlook in the oil and gas-based economies – despite the current downturn and the financial crisis. Until 2015, takaful is expected to grow at 17% per year (adjusted for inflation) to USD 7bn, which is faster than the conventional market. Takaful's market share is set to reach 8–10%. Insurance penetration should also increase.

Figure 21:
Takaful market share in Muslim countries is expected to rise from 4% in 2007 to 8% in 2015.



Source: Economic Research & Consulting estimates

Opportunities

Many factors favour the future development of the takaful industry …

A number of factors suggest that the takaful industry is set to grow in importance in the coming years. For example:

- The analysed markets – Bahrain, Indonesia, Malaysia, Saudi Arabia and the UAE – have strong economic fundamentals and growth prospects.
- The populations of Muslim countries are rapidly growing; the demographics are also favourable.
- Shariah scholars agree that Muslims should refrain from buying conventional insurance if a takaful operator is selling the same product, and offering similar benefits and services.
- Increasing Islamic consciousness has resulted in Muslims switching from conventional insurance to takaful products; there is a tendency to rely less on necessity (dharurat) to justify the use of conventional insurance.
- The insurance markets are underdeveloped, particularly in the Middle East. In most countries, the personal lines business is very small, and life insurance has not yet been fully developed. Takaful can play a key role in raising insurance awareness.
- The number of companies – global, regional and local – that have set up new takaful operations has grown significantly over the past five years. The new players, who often have a higher capitalisation and a multinational approach to takaful, are expected to raise consumer awareness, revive the markets with new competition and stimulate growth.
- Takaful may be an attractive solution for Muslims and non-Muslims. Once takaful players achieve critical mass and offer comparable prices, the opportunity to share in the profits from the takaful pool may attract non-Muslims as well – as the observation of some market practitioners in Malaysia would suggest.
- Islamic banking has boomed over the past thirty years, while takaful is still in its early stages. The success of Islamic banking is expected to benefit takaful. Furthermore, the distribution of insurance products by banks is increasingly popular (see Swiss Re *sigma* No 5/2007, "Bancassurance: emerging trends, opportunities and challenges"). Particularly in urban areas, bancatakaful – the distribution of takaful products via banks – could play a significant role in raising insurance awareness in the region. Banks could leverage their strong reputations by distributing simple protection savings products through their branches.
- Increased availability of highly rated retakaful capacity will further boost the growth of takaful.

Challenges

...if the significant challenges can be addressed.

Considerable effort will need to be taken by companies, regulators, shariah scholars and others to raise the awareness of takaful if the takaful industry is to live up to its potential.

Consumers and corporations

Persuading the consumer of the benefits of takaful is key.

For quite some time, Muslims have been told that insurance, and particularly life insurance, contradicts their faith. Despite the rulings of the Fiqh Academy and the rise of the takaful industry, many Muslims still share this view. Knowledge of insurance and its benefits is very low, especially in the Middle East. Individuals tend to downplay the need for retirement financing, opting instead to rely on family and the social security system. It will take time to change this way of thinking. While takaful has become a topic in the insurance industry, it has not yet pierced consumer consciousness. The recent introduction of compulsory business lines is expected to raise awareness. Nevertheless, companies and the government will need to step up their efforts to reach consumers and educate them about the benefits of takaful.

Price and service have to live up to consumer expections as well.

The takaful industry cannot rely solely on offering shariah-compliant products, as price and service also play a role. As seen in Malaysia, the distribution of surplus to policyholders can be a deciding factor when buying a takaful product. The service level and product features might also matter as much as conformity to Islamic beliefs.

Products

Microtakaful products could extend their reach to low income groups and raise their awareness of insurance.

Takaful products are an important innovation in the insurance industry. It is generally accepted that they will gain a strong foothold in the personal lines of business, where there are many small risks that can easily be pooled and shared among takaful participants. To gain the acceptance of low-income individuals, takaful may be offered as microtakaful. The main risks for low-income individuals include serious illnesses, bad harvests, education of children and death of relatives; such risks would be the main focus of a microtakaful product.[27]

When will corporate business move to takaful?

Another challenge exists at the other end of the spectrum. The market for large corporate and commercial business offers significant opportunities for takaful, particularly for investment projects handled by Islamic banks. This segment is currently insured by conventional insurers in the vast majority of cases. A change to takaful coverage could provide the sector with a large boost. Retakaful capacity will further grow in importance as a way of managing risk in the takaful pools.

[27] Allianz AG, GTZ AND UNDP Public Private Partnership, Microinsurance – Demand And Market Prospects, Indonesia, 2006.

Lack of regulation and standardisation

Lack of standardisation is limiting international reach, but efforts are under way to achieve convergence.

Diversity is inherent in Islam. It allows various interpretations to co-exist, hence, the various takaful models. Increasing standardisation of the operating models would help the takaful industry to grow on a global scale. The regulators in Malaysia or Bahrain have taken important steps to establish standards and enhance transparency. Standardisation will reduce costs, reduce confusion amongst customers and free up resources at financial institutions offering shariah-compliant products. However, it is likely that some differences in interpretation across the various schools of thought are likely to remain.

A common approach to the distribution of surpluses, the conditions for interest-free loans and ensuring the separation of shareholder and policyholders pools is needed.

Some convergence may occur because many shariah scholars are engaged in various companies and will apply the same judgements in different companies. However, this may lead to conflicts of interest. Also, issues such as the further development of regulations regarding the timely distribution of surpluses to policyholders, the conditions for interest free loans (qard al-hasnah), and the need to ensure separation of shareholder and policyholder pools will need to be addressed. However, some organisations are already increasing their efforts to introduce certain standards or principles. For example, the Islamic Finance Services Board (IFSB) and the International Association of Insurance Supervisors (IAIS) have been working to establish core principles that can be applied at takaful companies. The Accounting and Auditing Organization for Islamic and Financial Institutions (AAOIFIC) has also laid down accounting principles for Islamic institutions.

Available investment opportunities

Despite the strong growth of Islamic finance, tradable shariah-compliant assets are still lacking.

Despite the rapid growth of Islamic finance and the issuance of shariah-compliant assets, there is still a lack of tradable assets in the market. Global sukuk issuance, the Islamic equivalent of a bond, grew from USD 1bn in 2001 to USD 35bn in 2007. Global Islamic assets were estimated at USD 530bn in 2006.[28] Long-term sukuks, however, are usually oversubscribed and are not traded frequently. At times, takaful companies have had to invest in highly volatile regional equity or real estate markets and had fewer possibilities to diversify their risk with assets earning predictable investment returns.

Risk Management

Risk management is more limited for takaful firms as no derivatives can be used to control risks. The limited availability of fixed-interest investments can affect asset-liability matching. A lack of understanding about shariah could lead to non-shariah compliant products being sold inadvertently, resulting in a negative effect on the company's reputation.

[28] IFSL Research (2008). *Islamic Finance 2008*, London.

Qualified staff with insurance and shariah know-how are needed.

Human resources

Qualified staff with knowledge of insurance and shariah are scarce. It is even more difficult to find management staff and trained shariah scholars. There are ongoing efforts to establish takaful education programmes – eg in Malaysia and Bahrain – which will support the industry.

Re-takaful capacity is continuously growing.

Available retakaful capacity

Only a few years ago, retakaful capacity was quite scarce. The situation has now improved as many global reinsurers and some regional players have set up operations or are planning to do so. The further development of capacity will spur the growth of takaful.

Takaful operators face distinct corporate governance issues.

Corporate governance

Takaful operators must deal with additional corporate governance challenges that conventional insurers do not face. For example, the separation of assets between the takaful operator and the takaful fund can lead to an increased principal-agent challenge as the interests of the takaful operator and the participants are not fully aligned. This may require an organisational structure where the interests of policyholders within the takaful company are reflected. Despite the requirement of the takaful operator to provide an interest-free loan to the takaful pool in the case of a deficit, the operator is protected from the downside risks, which could encourage the operator to take too many risks.

Another corporate governance issue is the composition of the shariah board and its interaction with management. Appropriate checks and balances are needed for each of these stakeholders.

What it means for conventional (re-)insurers

Getting involved in takaful

Global companies have entered the market, supporting growth and bringing in expertise.

Many western insurance companies and reinsurance companies have already founded subsidiaries or set up takaful windows to serve the Muslim community with shariah-compliant products. Established companies are well positioned due to their reputation and their technical expertise. The most important factors for successful takaful operations are the transparency of operations, the establishment of shariah-compliant rules and a robust shariah supervisory board that guides product design and ensures shariah compliance.

International companies can leverage their good reputation.

While the mutual foundations of takaful may lead some to assume that this would conflict with the commercial goals of a global company, this has not been the case, as evidenced by the Islamic banking industry, where western banks play a substantial role. It is widely acknowledged that the further involvement of global western companies is beneficial to the development of the takaful industry because it will help bring more technical know-how into the sector. A similar role applies to global reinsurers with retakaful windows or dedicated takaful subsidiaries. The reinsurers' technical know-how can complement the takaful company's shariah know-how in a beneficial way.

Takaful: competition or generating new business?

Takaful could attract business away from conventional insurers mainly in non-life; it could stimulate the life market.

With the wider availability of takaful products, the question inevitably arises as to whether takaful will compete with conventional products. This is not so much the case in the Middle East, where life insurance is less developed. In fact, the new shariah-compliant offers could result in the creation of a new market, particularly for individual business, as is the case in Saudi Arabia. There, Bank Aljazira's Takaful Ta'awuni Division and SABB Takaful (subsidiary of HSBC) are successfully launching individual life savings and protection products – simultaneously shaping the life market. It is likely that current Muslim buyers will switch to an equivalent takaful alternative in non-life and compulsory business lines.

It will probably take more time and effort to persuade Muslims who have never bought insurance that takaful is shariah-compliant and provides benefits. However, in rapidly growing insurance markets, like the Middle East, the amount of leakage from the conventional sector is likely to be hidden by the overall strong growth. In the long run, takaful will help to grow the market substantially. Nevertheless, takaful could also draw the attention of non-Muslim buyers, leading to leakage from conventional insurance, as has been the case in Malaysia.

Conclusions

Muslims are underserved by the insurance industry.

Conventional insurance is incompatible with shariah, according to Islamic jurists (shariah scholars). While a shariah-compatible insurance industry is rapidly emerging, the roughly 1.5bn Muslims around the world are still underserved. Different Islamic insurance concepts are currently offered in Muslim countries, the most widely accepted of which is takaful, a form of insurance coverage based on mutual assistance and joint risk bearing. The vast majority of takaful companies today, however, are profit-oriented companies that operate under one of four different models. Their main feature is the segregation of policyholder funds (takaful fund) from shareholder funds. These companies must put a shariah-compliant investment strategy in place and set up an internal supervisory board of shariah scholars (Islamic jurists).

Takaful premiums were USD 1.7bn in 2007.

In 2007, 22% of the emerging markets economic output was from Muslim countries, while 11% (USD 45bn) of insurance premiums were written in these countries. Although reliable data is not always available, it is estimated that roughly 5% or USD 1.7bn in premiums have been written under takaful schemes. Between 2004 and 2007, the volume contributed by takaful was estimated to have expanded by 25% per year (adjusted for inflation).

Young, growing populations provide a solid base for the future growth of takaful.

Many Muslim countries have young and rapidly changing demographics, which should benefit economic and insurance market growth. Combined with the strong economic outlook in the Middle East and Asia, the prospects for takaful are positive. By 2015 , premium volume could expand to around USD 7bn globally, or 17% annual growth when adjusted for inflation.

The personal lines of business dominate in South and East Asia; in the Middle East, commercial lines dominate.

The patterns of the takaful markets in the Middle East and South and East Asia are quite different. While the conventional insurance markets in the Middle East are dominated by commercial lines of business and non-life insurance, life insurance and personal lines dominate in Malaysia and Indonesia. The concept of takaful, ie pooling similar risks mutually among participants, is more adaptable to smaller risks in the personal lines business, which is where takaful companies are mainly active. Insurance awareness in Malaysia, in particular, is higher than in the Middle East, where beyond the compulsory lines of business, the uptake of insurance by individuals is very low. In these countries, takaful operators will have to raise insurance awareness and educate consumers when selling their products.

The five countries analysed represent best practice and/or reflect the challenges and opportunities for takaful in the emerging markets.

Malaysia has put incentives in place to grow takaful; a level playing field exists in the Middle East.

Malaysia encourages the establishment of takaful companies by offering tax incentives and demanding lower minimum capital requirements. However, in the Middle East, regulators have created a level playing field in terms of regulation, with the same rules applying to both conventional insurance and takaful companies.

Free choice in most markets; only Bahrain prescribes a specific operating model.

Bahrain has the only regulator that prescribes the use of a particular model – a combination of wakalah (underwriting) and mudarabah (investments) for takaful companies. This is an attempt to achieve convergence and increase consumer acceptance. Generally, there is some convergence in the use of takaful models towards those prescribed by the Central Bank of Bahrain. Implementation still varies, depending on the interpretation of the respective shariah scholars.

More big insurers are entering the takaful market.

Initially, takaful companies tended to be small local ventures with a focus on shariah competence rather than on underwriting. In recent years, however, many new companies and takaful groups have been set up, eg the UAE-based SALAMA Group and Bahrain-based Solidarity, whose activities have a more international focus. Large global insurers are also entering the takaful market. While the presence of western companies may seem like a contradiction, their reputation, technical and distribution expertise and their capital strength appeal to Muslim customers. These attributes are also seen as positive for the development of the takaful market as a whole.

There is not much difference in distribution, but the need to educate consumers favours the agent approach.

The distribution channels used for takaful products are not much different than those for conventional insurance products. Direct sales and tied agents seem to be the favoured methods, particularly in markets where consumers need to be educated about the benefits of insurance products. The use of bancatakaful, the shariah-compliant form of bancassurance, is becoming more popular. Bancatakaful appears to be best suited for simple savings products or mortgage-related protection products.

Takaful is likely to spur growth in the industry.

In Muslim countries, takaful has significant potential. Whether it realises its potential depends on whether takaful companies will be able to convince their customers of the benefits of takaful products. The future of takaful also depends on the ability of companies to build and attract staff with shariah and insurance know-how. In addition, takaful operators will need to be able to market and sell their products to corporate customers. Moreover, the future of takaful will be influenced by external factors, such as the wider availability of shariah-compliant assets and the availability of highly rated retakaful capacity. A convergence of the applied models is also needed. If companies – with the support of regulators – rise to this challenge, the international takaful industry is well positioned to realise its full potential and attract customers from all over the world, regardless of their religious denomination.

Appendix: Bibliographic references

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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 the 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 al-hasnah: 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 al-hasnah 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.

[29] 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..

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.

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