

## Takaful Insurance Has Long-Term Viability And Benefits From Expected Growth, But Stiff Competition Persists

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# Takaful Insurance Has Long-Term Viability And Benefits From Expected Growth, But Stiff Competition Persists

## Overview

- Standard & Poor's Ratings Services continues to view the long-term growth and development of the takaful sector positively.
- 2009 was broadly a profitable year for companies we rate in the sector on a technical basis, excluding the results of start-up companies.
- 2009 showed continuing strong premium growth, generally ahead of the conventional insurance sector, although rates remained soft.
- Compared to three years ago, investment portfolios have lower exposure to equities, mainly due to falling valuations in our view rather than active de-risking.
- Saudi Arabia continues to be the main growth area for takaful. Around the Gulf Cooperation Council (GCC) region, medical business is pushing growth.
- Profitability in Malaysia's takaful sector improved in 2009, after a lackluster performance in both life and non-life sectors during 2008.
- Family business continues to show potential, but 2009 development has only been gradual.
- We expect greater operational efficiencies to develop, which could lower expenses and allow true economies of scale. Takaful fund surpluses could also develop more consistently for distribution to participants.
- We anticipate the development of surpluses on takaful funds, which will then be distributable back to participants.
- In the GCC region, an increasing obligation to employ local staff may be difficult to fulfil in the medium term in our opinion given the limited supply of suitably qualified candidates.

After another positive year in 2009, Standard & Poor's believes the takaful and retakaful (Islamic insurance and reinsurance) sector is likely to continue to grow in 2010. We believe that the long-term viability of these sectors remains supported by high expected levels of growth, broadly positive technical results, and an increase in profitability, particularly in the GCC region and Malaysia.

Nevertheless, while these positive factors should support the growth of the sector, we believe that the highly competitive and, in some cases, developing, nature of the local marketplace, as well as the impact of global investment markets on returns, continue to place an ongoing strain on sustainable development.

At the same time, we believe competitive pressures from within the sector, and from conventional insurers, means that success in this market requires careful navigation.

Since our first takaful rating in 1997, we have monitored the rapid development of an industry that we believe has benefited from the ongoing economic development in its core regions. Having grown from a niche product servicing limited demand, we believe that takaful has reached a critical mass in the past five years and is now firmly established within the global risk management markets. We consider the potential for sustained growth in this market is significant, buoyed by the still-low insurance penetration and the growing recognition and acceptance of

the concept of insurance and its benefits.

## **Company Structure Offers Choice When Establishing Takaful/Retakaful Companies**

A takaful operation can be established in a number of ways. These include setting up under the local country's Companies Act as a distinct legal entity, or as a subsidiary or "window operation" of an existing insurance company. However, in our opinion the question over which is the optimal structure remains widely debated.

We believe that fully fledged takaful operations benefit from a demonstrable commitment and dedication to Sharia compliance (activity that is consistent with the principles of Islamic law) and the concept of mutual solidarity. However, at the outset, takaful operations tend to have a still-developing business model and high start-up costs. In contrast, window operations are existing conventional insurers that undertake takaful business with safeguards for the separation of contributions and assets. They benefit from the ability to leverage existing infrastructure and costs.

Within Standard & Poor's credit analysis of takaful companies, we do not consider the decision to operate through a window operation or a separately incorporated entity as significant in itself. Of greater interest and importance in our analysis is the impact that this choice has, for example, on operational efficiency, acceptance by targeted customers, or competitive position through the potential increased capacity that a company can offer.

## **Rapid Premium Growth Continues**

Through our ongoing monitoring of rated takaful insurers in the GCC, we have seen continued very rapid top-line contribution growth. For many companies, the growth in gross contribution (equivalent to gross premiums written) was also reflected in net contributions (equivalent to net premiums written). In addition, in some cases net contribution growth outweighed gross contributions by a large margin, which in our view reflects an increased level of risk retention. In our analysis, we review performance on both a takaful and conventional basis. The latter is achieved by replacing wakala fees with management fees, which are shown in the shareholders' income statement.

Underwriting surpluses, defined as premiums less claims and underwriting expenses, are beginning to develop across the sector and contribute to the takaful fund. Furthermore, we believe there has been an improvement in investment returns since 2009. We measure the success of the takaful fund on the surplus generated.

In the Malaysian market, takaful insurers reported an increase in market share to 7.9% from 7.7% of the overall insurance sector from 2008 to 2009. We expect further growth in 2010, mainly due to the licensing of a new retakaful operator in 2009 and because a number of conventional insurers have acquired takaful licenses, which allows them to operate takaful windows. Total net contributions for insurers and takaful operators grew by 8.2% during 2009. We believe this was driven mainly by the ordinary life segment for the life and family takaful industry, and a broad-based demand for general insurance. We believe that Medical and Health Insurance (MHI) and Medical and Health Takaful (MHT) will continue to grow, owing to the improving socio-economic landscape. In 2009, total MHI and MHT gross direct contributions increased 22.6% from Malaysian ringgit (MYR) 0.9 billion in 2008 to MYR1.1 billion in 2009.

**Table 1**

<b>Gross And Net Contributions Growth 2008-2009</b>				
	<b>GCW year-on-year growth in 2008 (%)</b>	<b>GCW year-on-year growth in 2009 (%)</b>	<b>NCW year-on-year growth in 2008 (%)</b>	<b>NCW year-on-year growth in 2009 (%)</b>
Hannover ReTakaful B.S.C.	159.2	42.6	141.4	41.1
Takaful Re Ltd.	58.9	42.9	69.9	35.1
BEST RE	37.8	17.9	40.5	19.3
Saudi Re for Cooperative Reinsurance Co.*	0.0	1496.9	0.0	5333.3
Takaful International Co. BSC	52.6	7.1	25.8	6.9
First Takaful Insurance Co.	7.7	(19.3)	7.1	(13.6)
Wethaq Takaful Insurance Co. K.S.C. (Closed)	10.6	64.0	8.3	196.7
Malath Cooperative Insurance & Reinsurance Co.¶	182.6	179.2	1700.0	281.5
Tawuniya/The Company for Cooperative Insurance	22.9	71.8	27.1	79.9
Dubai Islamic Insurance & Reinsurance Co. (Aman)	66.3	0.5	54.5	(29.0)
Salama/Islamic Arab Insurance Co. (P.S.C.)§	42.2	18.5	43.4	16.4

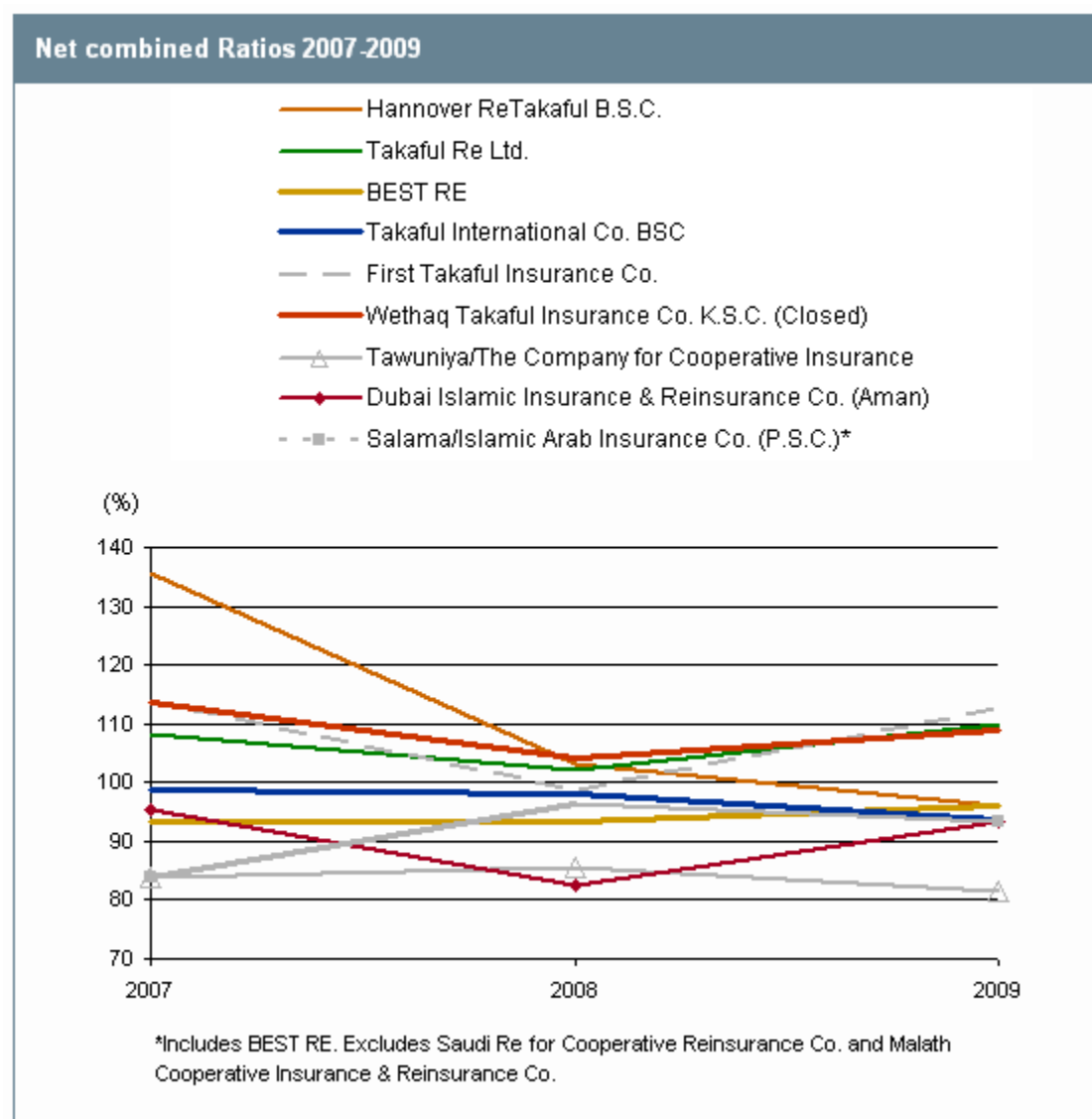
GCW--Gross contributions written. NCW--Net contributions written. \*Commenced writing business in 2009. ¶Commenced writing business in 2008. §Includes BEST RE.

## Expenses Impact Operating Performance

Compared with conventional insurers, we consider some takaful insurers to be in a start-up phase, which, under our criteria, lasts for the first five years of business. We believe that high levels of growth and high, but rapidly falling, expense ratios that reflect one-off costs associated with the establishment of the business demonstrate this.

Furthermore, this is compounded by some companies' exposure to markets that are experiencing a dramatic and unprecedented level of growth, due to structural changes such as the introduction and enforcement of compulsory lines of business. Medical business, in particular, has been a significant focus for many insurers, especially those in Saudi Arabia. In addition to personal lines, we believe the level of commercial business for takaful operators is increasing. This supports the market view that takaful operators are able to offer a full range of alternative products to the conventional insurance industry.

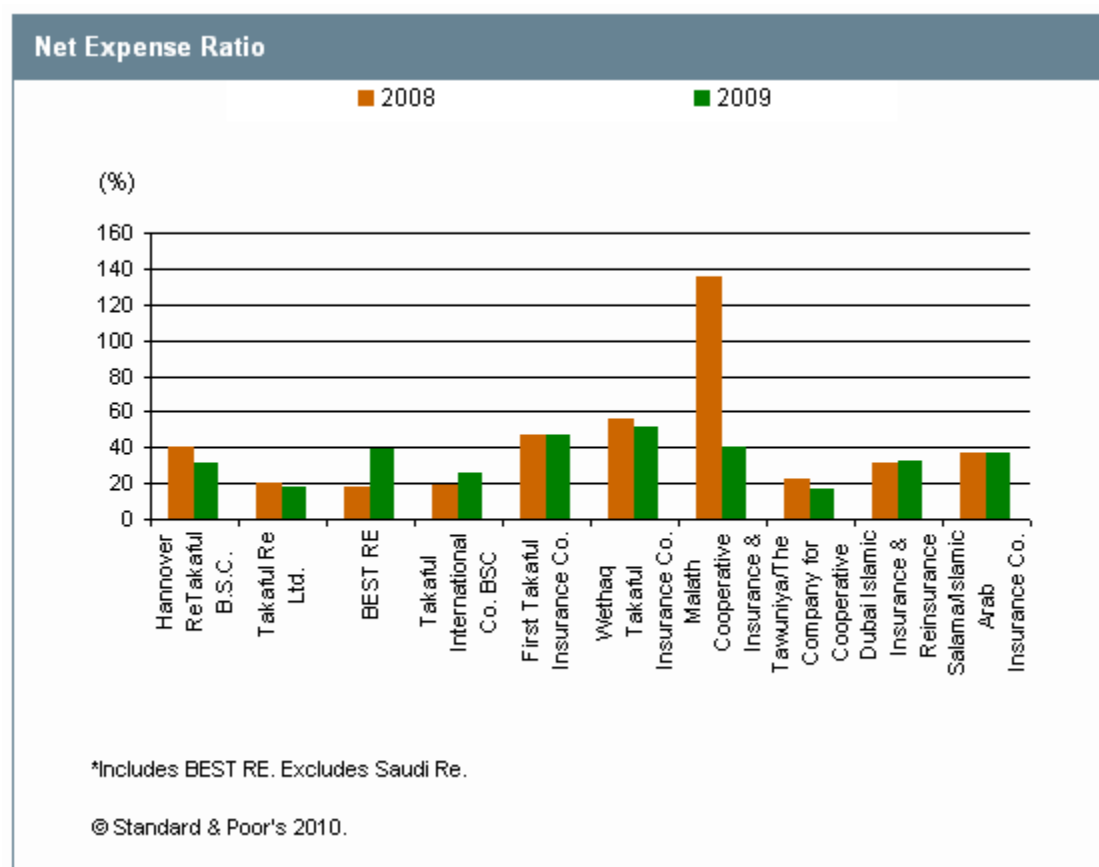
**Chart 1**



Once the pressures of establishing a new operation have eased, we consider that most operators are likely to achieve a net combined ratio in the mid-90% range. Furthermore, losses are generally around the same level as those in conventional insurance markets, and the skill of companies' underwriters continues to play a key role in the result. However, in our view expenses remain an issue for takaful operators. Two main factors affect this:

- For companies operating a wakala model, fees that are charged upfront do not necessarily reflect the actual level of expenses incurred by the shareholders in running the business. Although wakala fees are becoming more closely correlated with expenses incurred, we believe that the upfront nature explains why takaful companies have higher combined ratios than conventional insurers.
- Economies of scale are beginning to develop among the takaful players. We believe this is particularly important for those competing in the higher volume/lower margin lines such as motor and medical, which require operational efficiencies and sound underwriting in order to generate a technical profit.

Chart 2



## Capital And Risk Management: Lack Of Risk-Based Regulatory Supervision May Pose Problems

We believe that capital management remains an issue for takaful operators. More specifically, in our opinion, the lack of consistent and risk-based regulatory supervision of the takaful sector, particularly across the GCC region, means the takaful and conventional insurance sectors lack the growing sophistication of risk management and capital demand increasingly found in Europe and North America. We believe that this, in an unpredictably but rapidly growing market, puts pressure on the management team for control of risks. Furthermore, a tighter and all-encompassing risk management regime will require additional resources, which, in our view, would place further strain on already stretched resources.

In contrast, Bank Negara Malaysia, the insurance regulator in that country, aims to introduce a risk-based capital framework to run in parallel with the existing framework by 2011. In addition, industry and impact assessments are being undertaken in 2010.

## Investments: Focus On Equities

Table 2

Investment Portfolio Composition												
	Equities (%)			Bonds (%)			Cash (%)			Other (%)*		
	2007	2008	2009	2007	2008	2009	2007	2008	2009	2007	2008	2009
Hannover ReTakaful B.S.C.	0.0	1.0	1.0	0.0	18.0	16.0	100.0	81.0	84.0	0.0	0.0	0.0
Takaful Re Ltd.	24.7	14.8	15.9	15.4	19.3	17.3	59.9	65.8	66.8	0.0	0.0	0.0
BEST RE	31.9	21.2	19.2	0.0	0.0	1.0	60.7	71.6	73.3	7.3	7.2	6.5
Saudi Re for Cooperative Reinsurance Co.	N.A.	0.0	0.0	N.A.	0.0	11.2	N.A.	100.0	79.2	N.A.	0.0	9.6
Takaful International Co. BSC	50.7	51.0	42.0	0.0	0.0	0.0	32.5	33.4	45.0	16.8	15.6	13.0
First Takaful Insurance Co.	68.9	60.0	50.6	0.0	0.0	0.0	7.6	9.1	11.1	23.5	31.0	38.4
Wethaq Takaful Insurance Co. K.S.C. (Closed)	73.7	74.6	40.7	9.8	4.3	0.0	14.2	18.3	12.7	2.4	2.7	46.6
Malath Cooperative Insurance & Reinsurance Co.	41.3	18.5	16.3	56.5	23.2	17.9	2.2	58.3	65.8	0.0	0.0	0.0
Tawuniya/The Company for Cooperative Insurance	46.3	55.8	52.7	18.8	19.6	24.5	27.1	14.3	14.9	7.8	10.3	7.9
Dubai Islamic Insurance & Reinsurance Co. (Aman)	66.7	40.9	51.6	8.5	9.7	0.0	8.8	23.8	23.2	16.0	25.6	25.3
Salama/Islamic Arab Insurance Co. (P.S.C.)¶	44.3	30.2	23.3	25.2	3.2	16.4	14.4	51.3	47.9	16.1	15.3	12.5

\*Includes property, affiliates, and other investments. ¶Includes BEST RE. N.A.--Not available.

Investments remain an area of focus for takaful companies, partly because they are more limited in terms of assets that they are able to invest in. As a result, takaful companies typically have a bias for equity investments (see table 2).

Although a limited level of de-risking has taken place over the last two years, the change in the composition of investment portfolios for most takaful companies is likely to be due to the fall in equity valuations in our view. On average across our rated takaful universe, equities represent approximately 28.5% of a company's portfolio in 2009 compared with 44.6% in 2007. Furthermore, while we believe that equities have performed badly--the Dubai Financial Market General Index and Tadawul All Share Index in Saudi Arabia fell peak-to-trough over the last three years by approximately 75% and 65%, respectively--the growth in business written has resulted in cash balances increasing. In the event that equity markets recover, we would expect the proportion of equity investments to rise, although perhaps not to the same levels seen in 2007.

In our view, Malaysia has emerged from the investment market turmoil relatively unscathed, although investment income levels which had previously dipped have shown some recovery in 2009.

## A Few Hurdles Left To Clear, But Potential For Sustained Growth Is Significant

We believe that the takaful sector will continue to prosper in the coming years. This is due to the increasing acceptance of the takaful concept and increased levels of business from compulsory lines and corporate business, which in our view should help provide a regular and stable stream of business. We expect this growth to enable true economies of scale, with expenses accounting for a progressively lower proportion of the combined ratio in future years.

We will be monitoring the development of takaful windows to see if the benefits of capacity and economies of scale

brought by large conventional insurers can tempt contributions away from existing separately incorporated companies.

We believe that family business, although at an early stage in its development, is demonstrating potential. A number of companies are therefore seeking ways to exploit this, namely through distribution partnerships and new products. In Malaysia and the GCC, family takaful--like its conventional life assurance cousin--remains a small but strongly growing line of business.

Although unlikely to have an impact in the immediate future, we believe that the limited supply of appropriately qualified and experienced individuals could constrain the long-term development of takaful companies. We believe this is particularly the case in the GCC where governments are placing an increasing emphasis on employing nationals in preference to expatriate staff. We expect demand for staff to remain high, especially given the growth prospects for takaful companies.

We expect the takaful model to mature into one that provides effective mutuality of risk (risk sharing) through the takaful fund to its members, leaving shareholder funds to act essentially as investment funds that provide support via the "qard hasan" (interest free loan) at times of extreme loss events only.

We expect the growth in current and new lines of business, together with the benefit of economies of scale and greater stability, to allow the development of a surplus that will be available for distribution to policyholders. Although we see that challenges persist in the takaful sector, we believe that the potential for sustained growth and development there is significant.

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