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Malaysia's 30 years experiment with the hybrid takaful model

- Is it time for Takaful 2.0?

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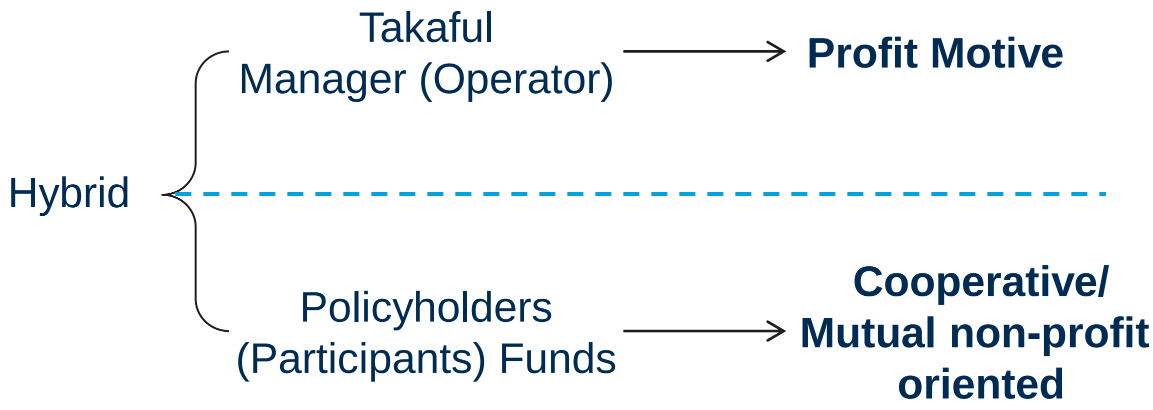
The generic hybrid takaful model

- Takaful as currently practiced is a hybrid:



- Operator will provide **solvency capital** and **working capital** in return for a pre-determined fee. The operator would normally be obliged by the regulator to provide an interest free loan (*qard)* to the participants fund should a need arise.

- In return the operator sets the basis of his remuneration. The participants have no say on the determination of this basis.

How the hybrid model evolved in Malaysia

- First model was the *Mudharabah* model
  - treats ‘underwriting surplus’ as ‘profits’ within the context of the *Mudharabah* contract.
  - aligns the interest of shareholders to policyholders but very difficult for shareholders to generate profits as net profits would be earned only after all expenses have been met.
  - contribution rates (i.e. premium rates) were generally higher than conventional insurance. However, as there was only <u>one</u> takaful operator during the early years the business model was still successful (albeit slowly!). The composite structure of the business was also a contributing factor to its success.

- Current model of choice is the *wakala* model with shareholder sharing in the underwriting surplus of the participants pool.
  - this model allows the operator to generate income to meet expenses regardless of whether the participants pool is in a position of surplus. However, the alignment of interest between participants and shareholders is relatively weak.

Observations on the operating models for takaful

- Utilization of ‘trade’ contracts (i.e. *Mudharabah* and *Wakala*) to apply to insurance transactions.
  - these contracts predates Islam but are compatible with shariah standards. However, their applicability to the hybrid takaful model is suspect.
  - These contracts for various reasons are generally unsuitable for takaful (in the way it is currently implemented).
- There are no reasons <u>not</u> to create a new shariah compliant contract for takaful. The November 2013 International Islamic *Fiqh* Academy meeting has made an attempt to do this but so far no traction can be seen.
- Regulators are reluctant to differentiate takaful from insurance from the capital and solvency perspective, as a result we have seen a convergence in products and services rather than the expected “disruption” of the insurance marketplace by the takaful operators.

Reflections on the current Malaysian takaful industry
- Issues with the Industry

- The current takaful model suffers from inherent weaknesses;
  - The shareholder-participant operating model creates conflicts between the shareholders drive for profitability (through selling more profitable savings and single contribution type products rather than lower premium protection products) and the need to provide basic protection products for the lower income segment of the population.
  - The implicit need to guarantee takaful benefits means that the cost of RBC/minimum capital needs to be factored into the pricing.
  - The agency distribution system still dominates the takaful/insurance market in Malaysia. This distribution method is expensive and also does not extend to the lower income segment of the population.
  - Takaful operators are new. Many takaful operators have yet to attain economies of scale due to the need to build a distribution channel from “scratch”. This delay in covering operating costs results in persistent expense overruns which in turn depletes the operators’ capital. **In insurance underwriting profits may offset such losses but not in takaful.**

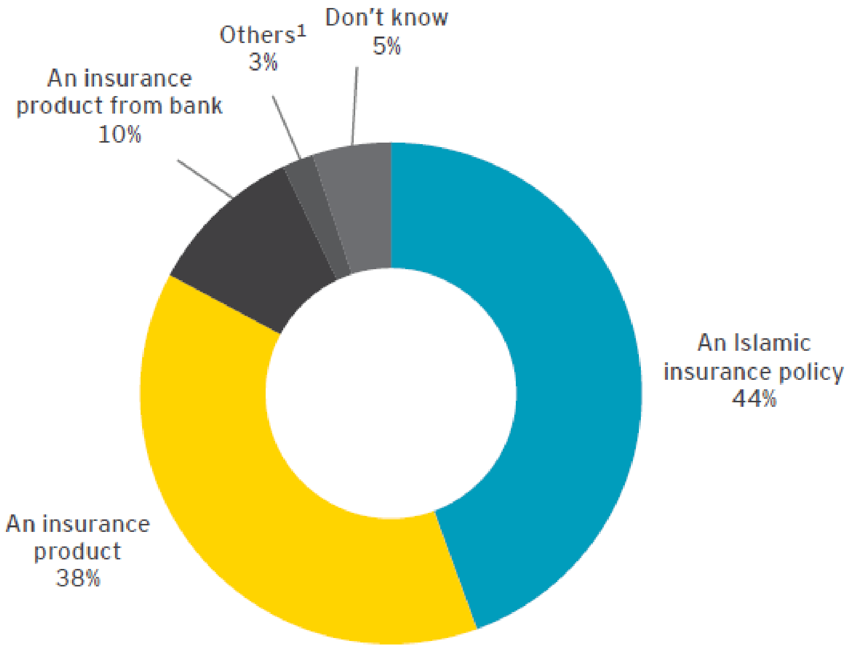
Reflections on the current Malaysian takaful industry
- Minimal differences in consumer experience

- Other than those operators who are able to distribute surplus back to the participants, particularly in general takaful, the **consumer experience** with takaful is not very different to buying conventional insurance. With diminishing underwriting surplus (for example as a result of detariffication in the motor segment) the amount of underwriting surplus that can be distributed back to participants can be expected to also diminish. This would lessen the attraction of takaful to consumers, especially non-Muslims participants.

- Some takaful products are also mis-sold as intermediaries/agents either overpromised or the participants do not understand takaful themselves. This in part is due to a lack of financial education at the individual participant level, especially for the lower income segment of the population.

- With increasingly minimal differences in consumer experience between takaful and conventional, the choice (especially for non-Muslims) will come to price. Takaful cannot compete with insurance on price. This is due to a combination of the operating model in use and the lack of scale experienced by many operators. Ultimately this situation can lead to a contraction in the takaful industry.

General opinions on takaful



Perception of takaful	
1	Most of them perceive it as Islamic insurance. However, most admit to having little knowledge of how it works; only a few has some basic knowledge.
2	Some believe that takaful offers the same types of products as those in conventional business as well as similar coverage and benefits.
3	General takaful: more for self or personal coverage, i.e., life insurance, motor and personal accident. Family takaful: extends the coverage beyond self to include the family, i.e., medical for family, home and education. We note that most of them have inaccurate awareness about takaful.
4	Most admit to not really knowing the main differences between takaful and conventional insurance. Islamic theme was rarely mentioned by respondents.

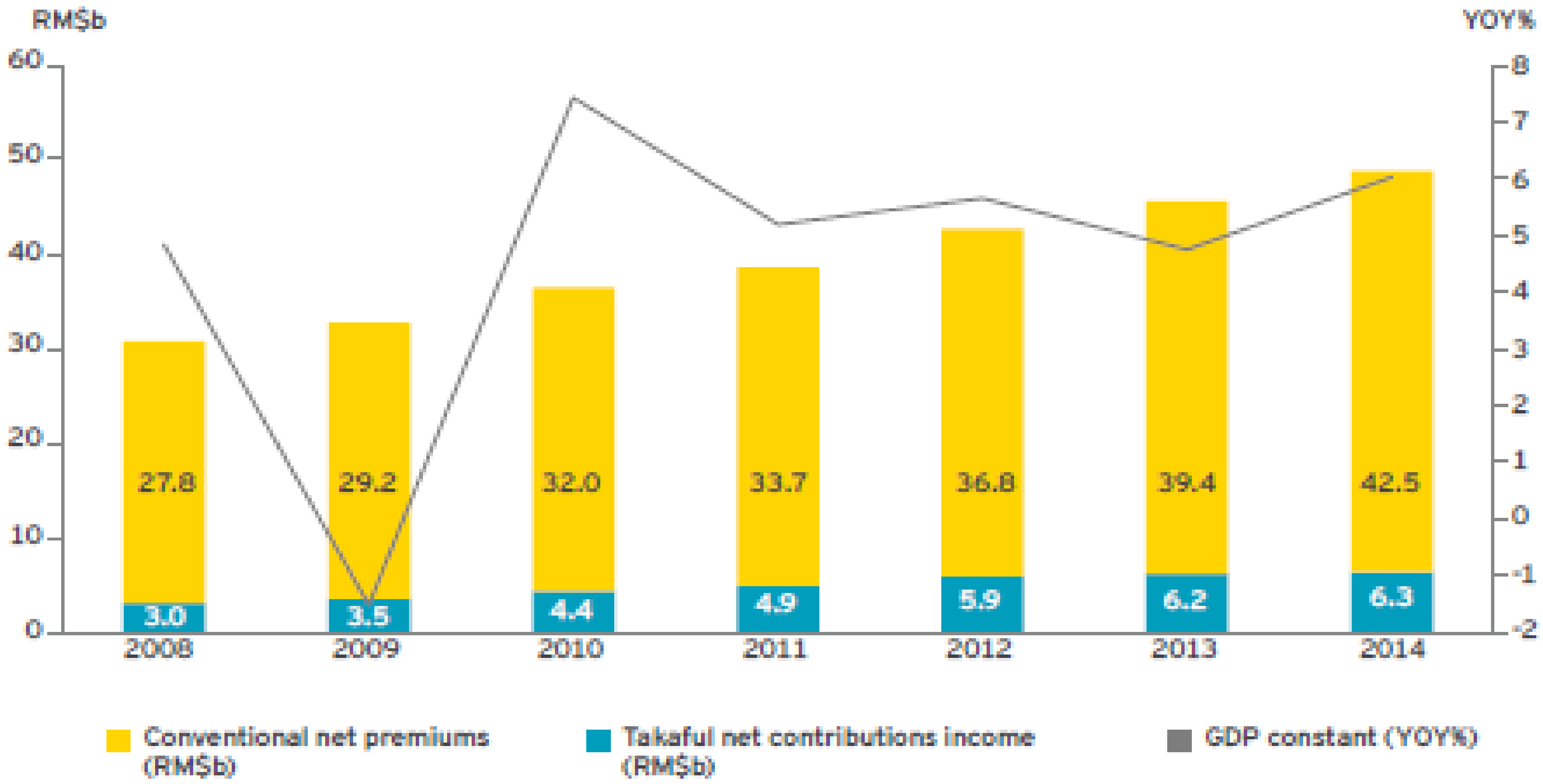
Note:
[1] Others includes investment, saving and charity fund.

Source:
- *Environment Scan on Takaful Awareness for Malaysian Youth, Metrix Research, September 2014*

Takaful Players in Malaysia

- Currently, there are **11 Takaful Operators** ("TO") in Malaysia: **3 are purely Family** takaful business while **8 has Composite takaful licenses**. There are currently no stand alone general takaful operator.

How is takaful faring in Malaysia?
- Malaysia's insurance, takaful and GDP growth

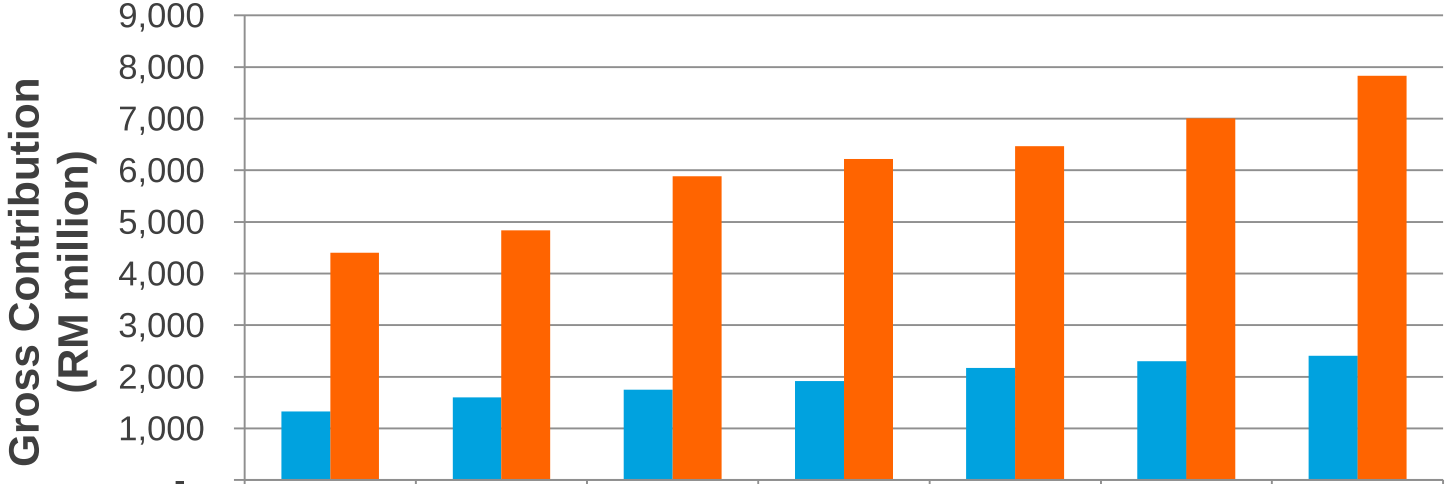


Source:

- *Economic Outlook Database April 2015, International Monetary Fund;*
- *Financial Stability and Payment System Report 2013 & 2014, Bank Negara Malaysia;*
- *Monthly Statistical Bulletin, May 2015, Bank Negara Malaysia;*
- *EY analysis.*

How is takaful faring in Malaysia?
-Gross contributions

- Total gross contribution* for Takaful is estimated at RM10.2 billion in 2016, an increase of 10% from RM9.3 billion in 2015.
- The Compound Annual Growth Rate (CAGR) between 2010 and 2016 is 10% for both General Takaful and Family Takaful.



	2010	2011	2012	2013	2014	2015	2016
General Takaful	1,330	1,600	1,746	1,918	2,169	2,300	2,408
Family Takaful	4,399	4,834	5,883	6,219	6,467	7,008	7,831

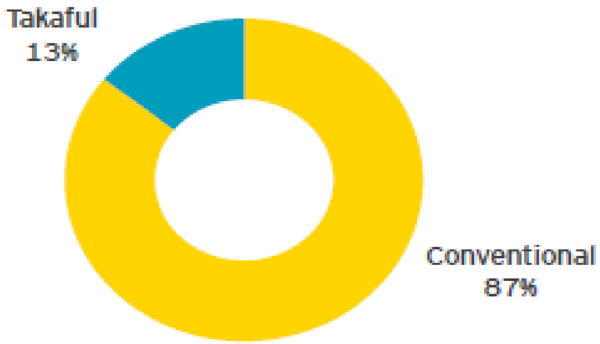
	General Business	Family Business	Total Takaful Business
2010 – 2016 CAGR	10%	10%	10%

* Total gross contribution from Family Takaful includes new business and inforce contributions.

Source: Actuarial Partners' analysis of ISM Statistical Bulletin and ISM Statistical Yearbook

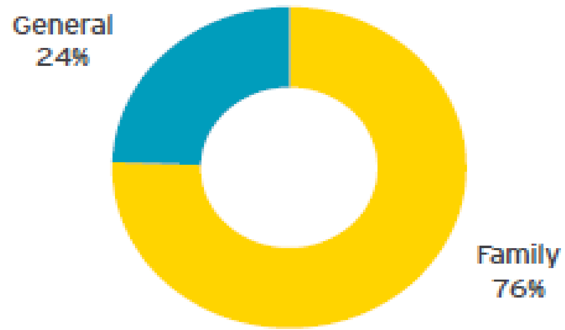
How is takaful faring in Malaysia?
-Comparison with conventional insurance

Malaysia – share of conventional versus takaful, 2014



CAGR (%) 2009 - 2014e	
Conventional net premiums	7.8
Takaful net contributions	12.4

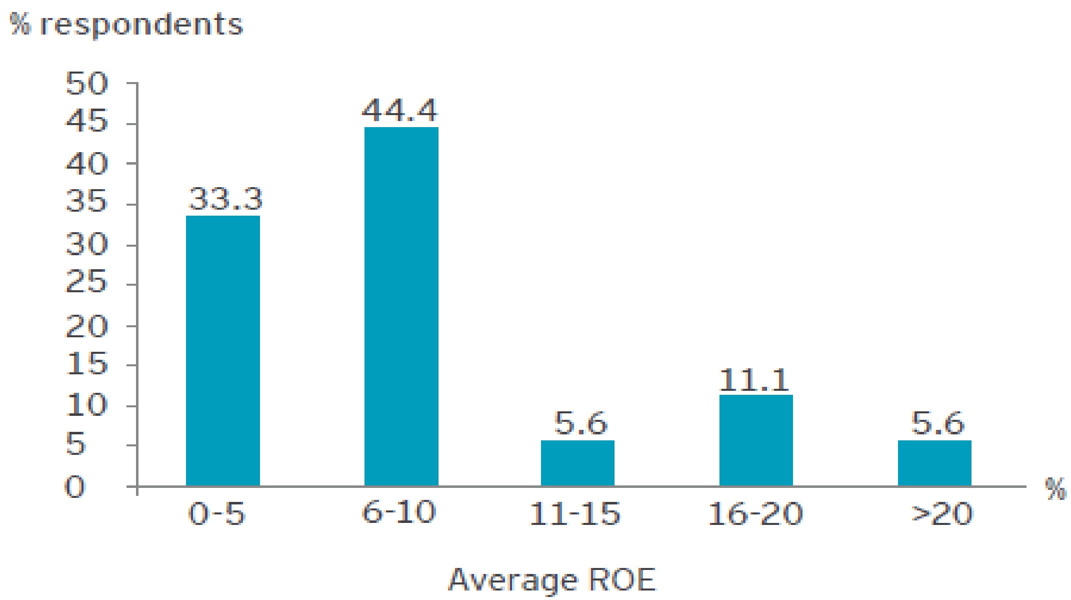
Malaysia – share of family versus general takaful, 2014



CAGR (%) 2009 - 2014e	
Family	11.9
General	14.0

Source:
- *Statistical Yearbook (General Insurance & Takaful) 2013 & 2014, ISM;*
- *Financial Stability and Payment Systems Report 2014, Bank Negara Malaysia*

How is takaful faring in Malaysia?
- Average return on equity for Takaful Operators



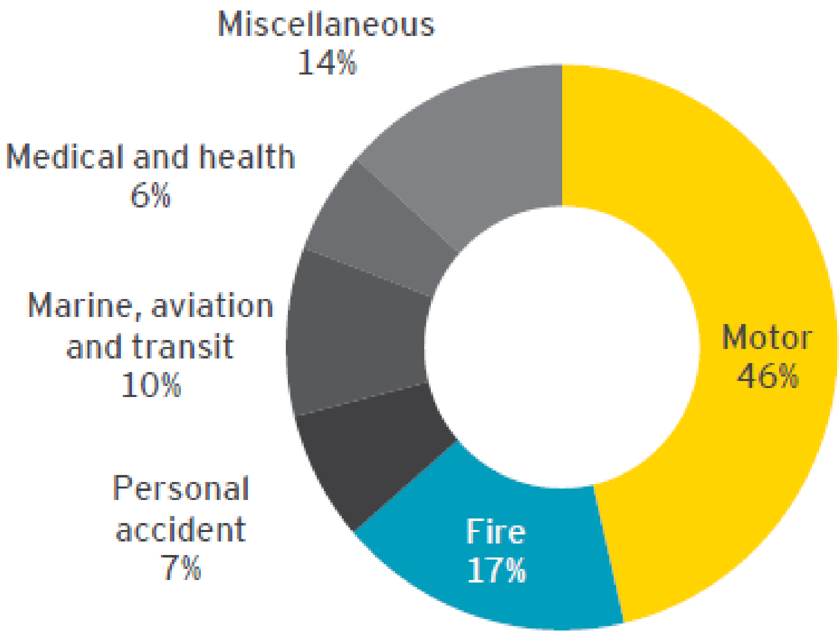
On average, nearly half (44%) of respondents indicate an average return on equity (ROE) of about 8.1%.

Notes:
Online survey period was from 28 May to 8 July 2014. Total survey respondents was 21.
The mean result is derived from cumulative frequency.

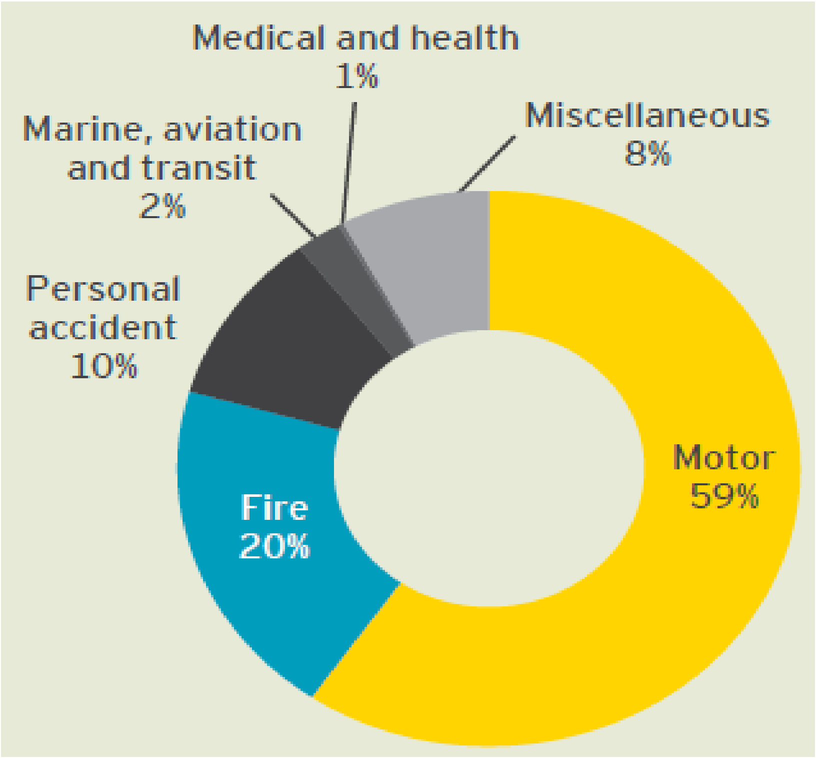
Source:
- *Global Takaful insights 2014, EY*

Focus on General Takaful
- What drives business?

General insurance portfolio mix

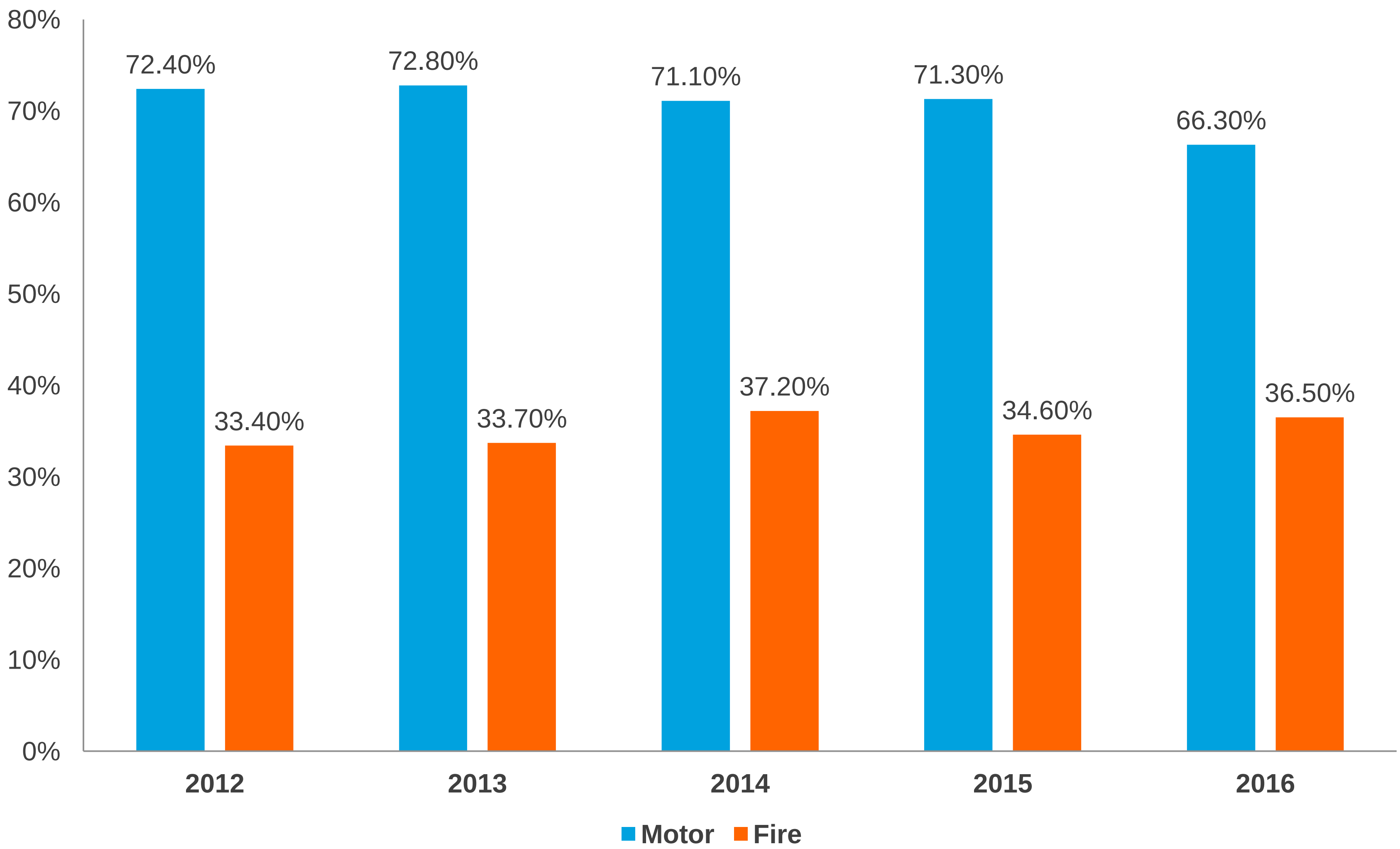


General takaful portfolio mix



Source:
- *Statistical Bulleting Market Performance (General insurance & General Takaful) 2015, ISM*

Malaysia motor and fire claims ratio



Source: *BNM*

What is supporting the profitability of the general Takaful business in Malaysia?

- There are certain unique drivers that makes general takaful business profitable in Malaysia which may not be present in other markets.
  - General takaful benefits in the ability to share capital and expenses within a composite takaful operator structure.
  - The two major lines of business, motor and fire are tariff based, rates are the same for takaful and insurance. These tariffs are in total, profitable and are the drivers of the industry.
  - Takaful products, for the same premium as charged by the insurance companies, provides for the sharing of underwriting surplus with the participants. This makes motor and fire takaful in particular an attractive proposition even for non-muslim participants.
  - Limited issuance of takaful licenses also helps to reduce competitive pressure.

Stormy clouds on the horizon for the takaful industry

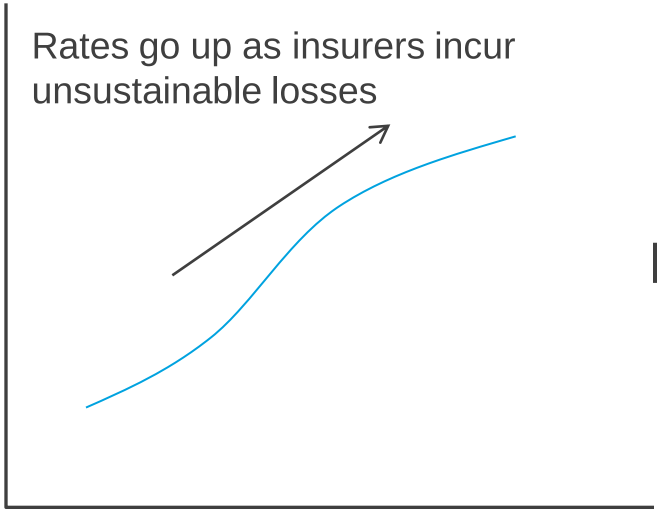
There are several major changes in the pipeline for the insurance/takaful industry which does not bode well for the takaful operators. These include:

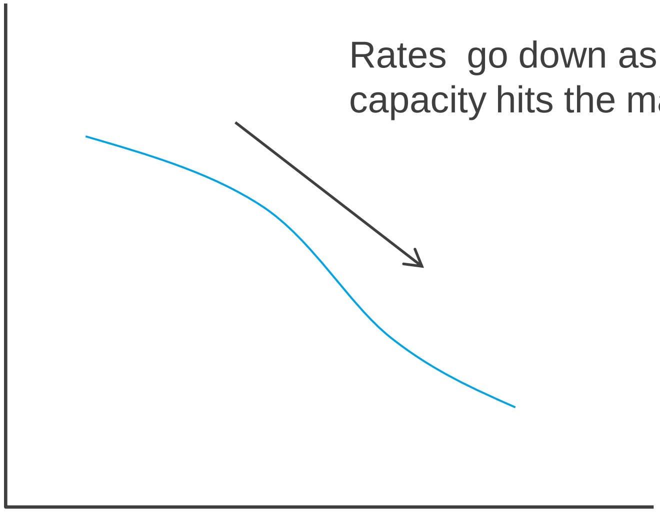
1) Removal of the motor and fire tariffs – this means takaful would need to compete on price with insurance and with other takaful operators.

2) Composite takaful operators are required to split their business to family and general takaful. This would increase operational costs and reduce shareholders return on equity even if there are no changes in expenses.

3) Removal of regulatory limitations of management expenses and commissions. This means the smaller players (which are most of the takaful operators) would be at a disadvantage when competing with the bigger insurance companies.

The bane of takaful operators
-The underwriting cycle





Opportunity to recover losses from previous downturn

Takaful operator makes a surplus Which is distributed to participants

Protecting market share through a strong balance sheet

Takaful operator funds deficit through a Qard

In a competitive market takaful operators are in a disadvantaged position

Takaful shareholders can expect fewer profits as compared to shareholders of insurers when they compete on price

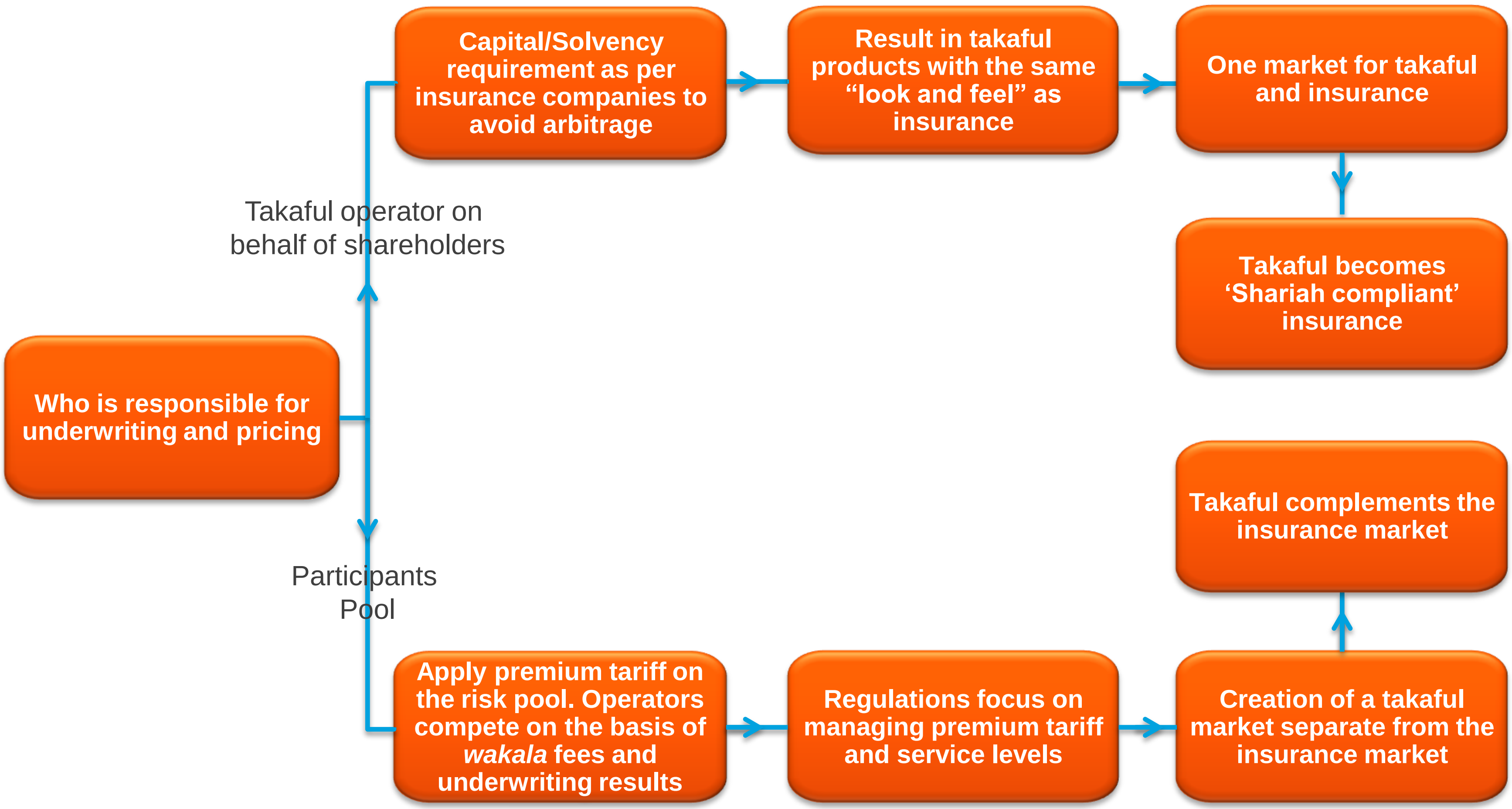
- In **an upmarket**, shareholders profits are limited

Source of Income	General Takaful Wakala on contributions Mudharabah on Investments	General Insurer
Underwriting profits	100% to participants	100% to shareholders
Investment income on technical reserves	x% to shareholders	100% to shareholders
Expense underrun profit	Limited by wakala fees	100% to shareholders

- In **a down market** takaful shareholders need to provide capital support, no different from a general insurer except it is through a *qard*, an accounting entry, but to all intents and purposes having the same effect on solvency as a shareholders capital injection.

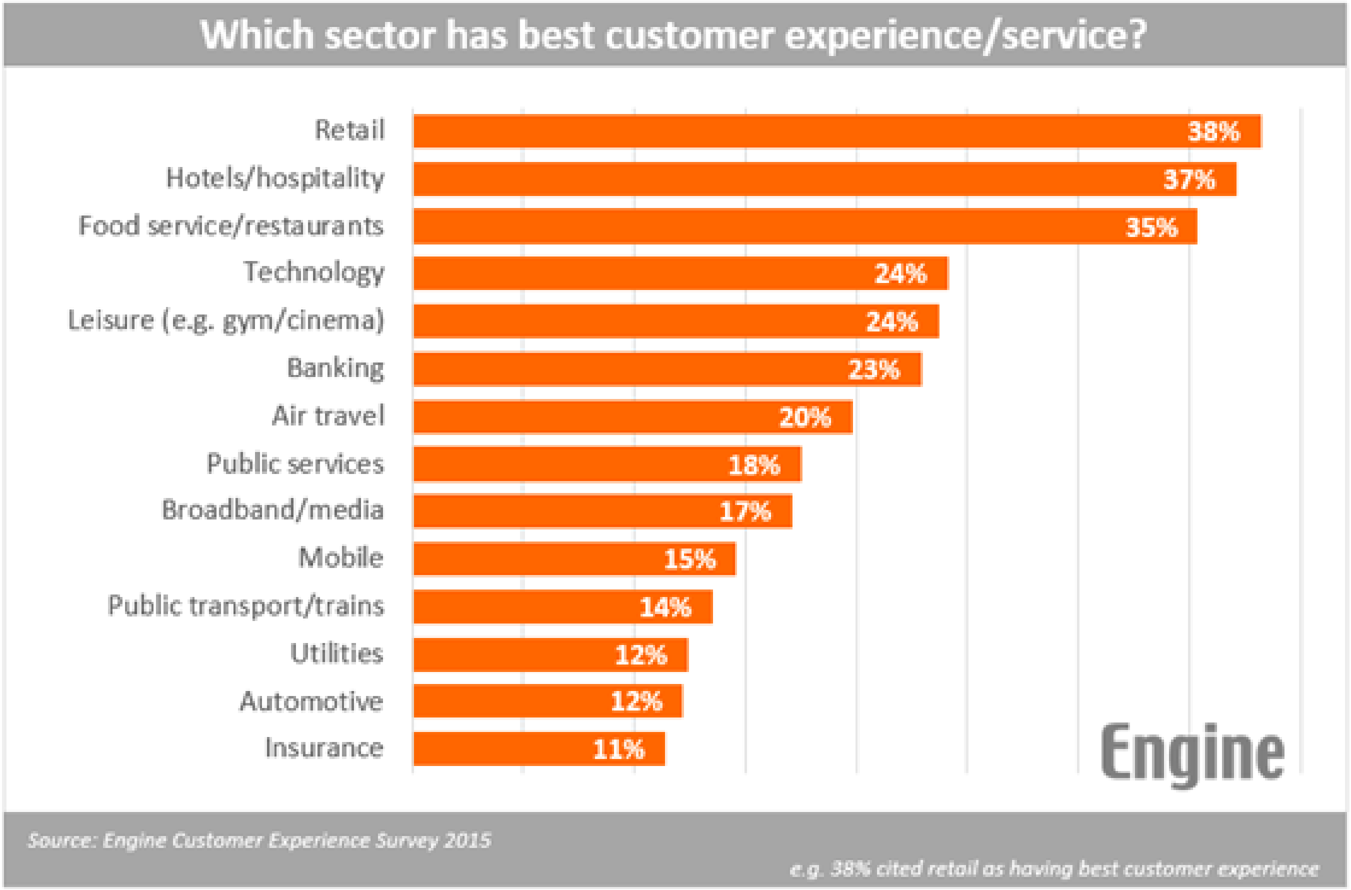
Thus, general insurers shareholders tend to be better suited to profit from underwriting cycles then takaful shareholders

Options for developing the takaful market in a mixed economy



Takaful – an opportunity to “reboot” the insurance industry
Promoting a different consumer outcome

- Consumer experience of insurance tend to lag those in other services industry globally.



What can happen when there is excessive competition
-UAE 2015 Statistics

Class of Business	Premium %	Loss Ratio %	Retention Ratio %
Medical	47.8	91.9	59.1
Accident & Liability	34.3	73.1	62.4
Fire	8.4	90.2	15.8
Land, Sea & Transport	6.0	42.5	20.9
Others	3.5	6.9	40.2

Source: UAE Insurance Authority

Implications on UAE Takaful Operators

- Underwriting Surplus are dependent on class of business underwritten, Medical and Fire are definitely unprofitable
- Retakaful operators are probably “hurting” given a significant chunk of fire and medical are ceded
- Without underwriting surplus takaful operators are dependent on investment profits from their assets under investment, especially on shareholders capital. Bulk of investments on equities and properties.
- Once RBC is fully implemented there will be greater pressure on return on capital.

Why Takaful 2.0 is required?

- It is becoming evident that takaful's differentiating factors are becoming more cloudy, this has to do with the over "commercialization" of takaful. The drive for profit to be 'the same' as insurance has several unintended consequences;
  - Limited product differentiation when compared to insurance
  - Generally ignoring the protection needs of the lower income segment of the population
- The growth of takaful is slowing down in Malaysia and with detariffication looming and the need to split the composite license the general takaful sector's profitability will be severely challenged.
- On the underwriting side the demise of a few retakaful operators do not bode well for the takaful industry.
- Is the hybrid takaful model in need of a makeover? Should we not consider "going back to basics"? Risk sharing rather than risk transfer…

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