Perspective on Takaful Regulation and its Impact on Ratings

Cairo

19 February 2013

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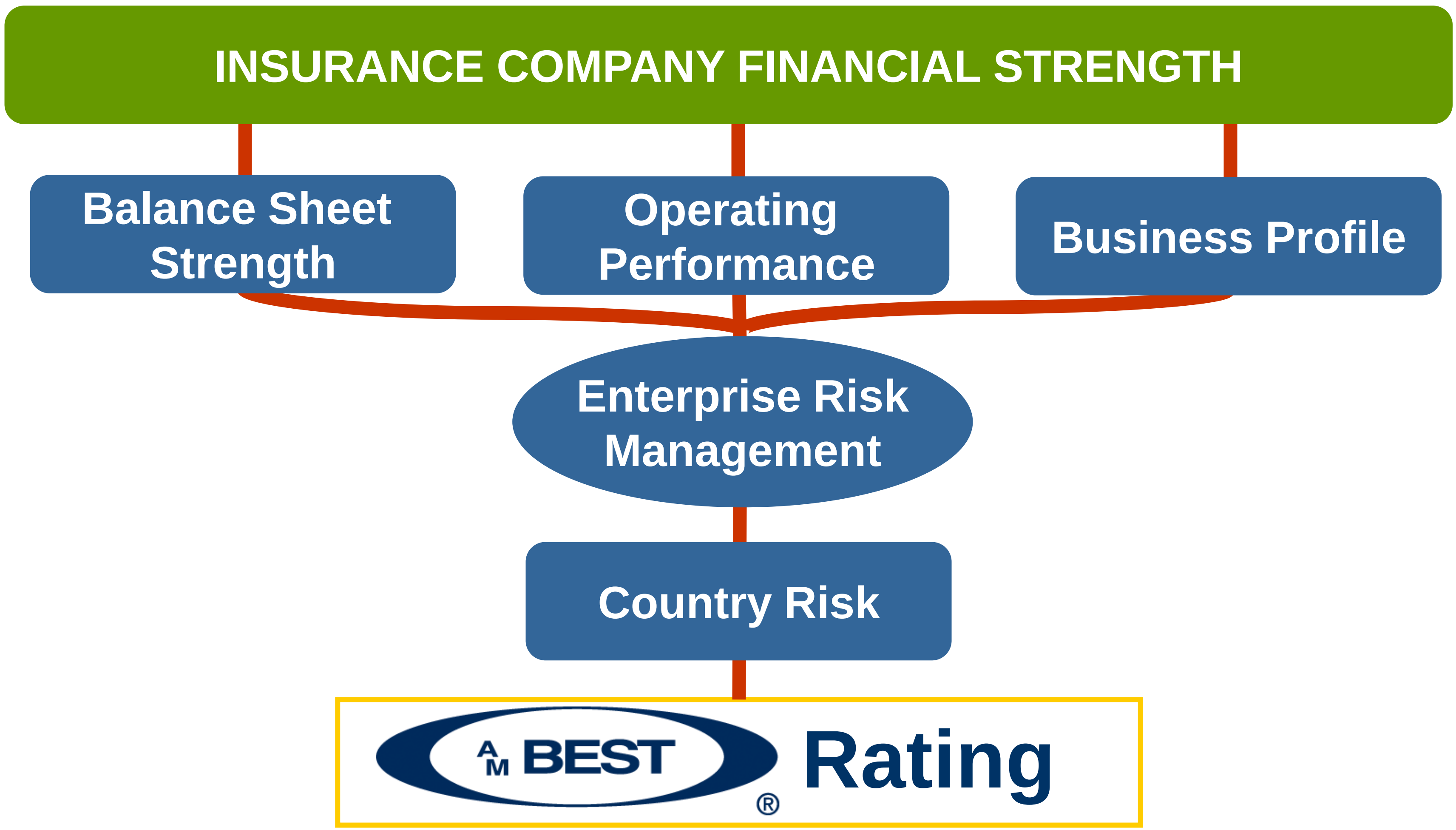
Disclaimer

What is a Financial Strength Rating

- An independent opinion of an insurer's financial strength and **ability to meet its on-going insurance policy and contract obligations** based on a comprehensive quantitative and qualitative evaluation
- Not a warranty of a company's financial strength
- Is intended to be prospective
- Value depends upon the market credibility of the rating issuer
- Supported by impairment studies
- Relates to a legal entity not a group

A.M. Best's focus is on interactive rating analysis engaging with senior insurance company management

Financial Strength Ratings



An opinion as to an insurer's financial strength and ability to meet its ongoing obligations to policyholders

Country Risk Analysis

- Identifies risks unique to a given domicile and common to insurers based or operating in that domicile
- Specific risks include, but are not limited to:
  - Insurance market and regulation
  - Business and legal environments
- Economic stability and trends
- Financial volatility and banking system stability
- Political and regional stability
- Country Risk analysis is included in the financial strength analysis of an insurance company

A.M. Best's country risk analysis places no ceiling/cap on company ratings – regulatory regime is critical

Balance Sheet Strength

- Risk-adjusted capitalisation
- Capital structure
- Financial flexibility
- Liquidity
- Quality/soundness of reinsurance
- Adequacy of loss reserves
- Debt leverage/interest coverage

AM Best's Capital Adequacy Ratio (BCAR)

NET REQUIRED CAPITAL	TOTAL ADJUSTED CAPITAL
+ Fixed-Income Securities + Equity Securities + Interest Rate + Debt Securities + Loss Reserves + Net Written Premium + Off Balance Sheet Risks - COVARIANCE	+ Shareholders funds + Positive adjustments. Typically: Discounting of reserves Difference between market and book values Economic Reserves Hybrid Equity - Negative adjustments: Deduction of one cat PML DAC

BCAR SCORE = TOTAL ADJUSTED CAPITAL / NET REQUIRED CAPITAL

Equity Characteristics

1. **Permanence:** needs to be available at all times to pay insurance company’s obligations

2. **Ability to defer interest or dividend payments:** ensuring that the insurer is not de-capitalised in periods of financial strain

3. **Subordination in an insurer’s capital structure:** policyholder liabilities have priority in cases of insolvency

Complications Arising from Takaful Model

1. **Permanence**
   - Most Policyholders' Funds (PF) depend on Qard Hassan for their viability
   - As Qard Hassan is pre-eminently a loan it should be repaid if it becomes clear that the Policyholder Fund is unable to return to profitability
2. **Ability to defer interest or dividend payments**
   - Dividends can be (and in most cases are being) paid from the Operators Fund while the Policyholder's Fund is loss making
3. **Subordination in an insurer's capital structure**
   - Scholars have opined that there is no subordination in Shariah law

ADDITIONAL CONSIDERATIONS

A. **Existence of multiple Policyholders' Funds in the same company:** is it possible for one PF to support another? If not how is the Equity apportioned?

B. **Prevailing law in case of insolvency:** is a Takaful company likely to be wound-up according to Shariah or Secular law and jurisprudence

Capitalisation of Takaful companies cannot be evaluated in the same way as that of traditional insurers

Regulatory / Legal Frameworks can Provide Clarity

1. **Permanence vis a vis Qard Hassan**
   - Ensure that Qard Hassan remains for the period that the PF remains deficient
   - Adopt rules under which Operators "write-off" the Qard Hassan even though the PF may be returning to profitability

2. **Ability to defer interest or dividend payments**
   - Set up rules under which dividend is being paid

3. **Subordination in an insurer's capital structure**
   - Ensure priority of Policyholders over all other liabilities

ADDITIONALLY, STRONG REGULATORS TEND TO:

A. Work with legislators to ensure insolvency rules take into account specificities of insurance industry and Takaful model in particular

B. Encourage companies to establish strong ERM

The GCC Takaful Regulatory Landscape

COUNTRIES	SPECIFIC TAKAFUL REGULATION IN PLACE	OBLIGATION TO PROVIDE QARD HASAN	PERMANENCE OF Q'ARD HASAN	POLICYHOLDER PRIORITY
BAHRAIN	YES	YES	YES	NO PROVISION
KSA	NO[1]	NO[2]	NO	NO PROVISION
KUWAIT	NO	NO[2]	NO	UNCLEAR
OMAN	NO	NO[2]	NO	UNCLEAR
QATAR	NO	NO[2]	NO	UNCLEAR
UAE	YES	NO[2]	NO	MOST SENIOR
FREE ZONES				
DIFC	YES	YES	YES	MOST SENIOR
QFC	YES	YES	YES	NO PROVISION

[1] In KSA the same regulation applies to traditional and takaful companies

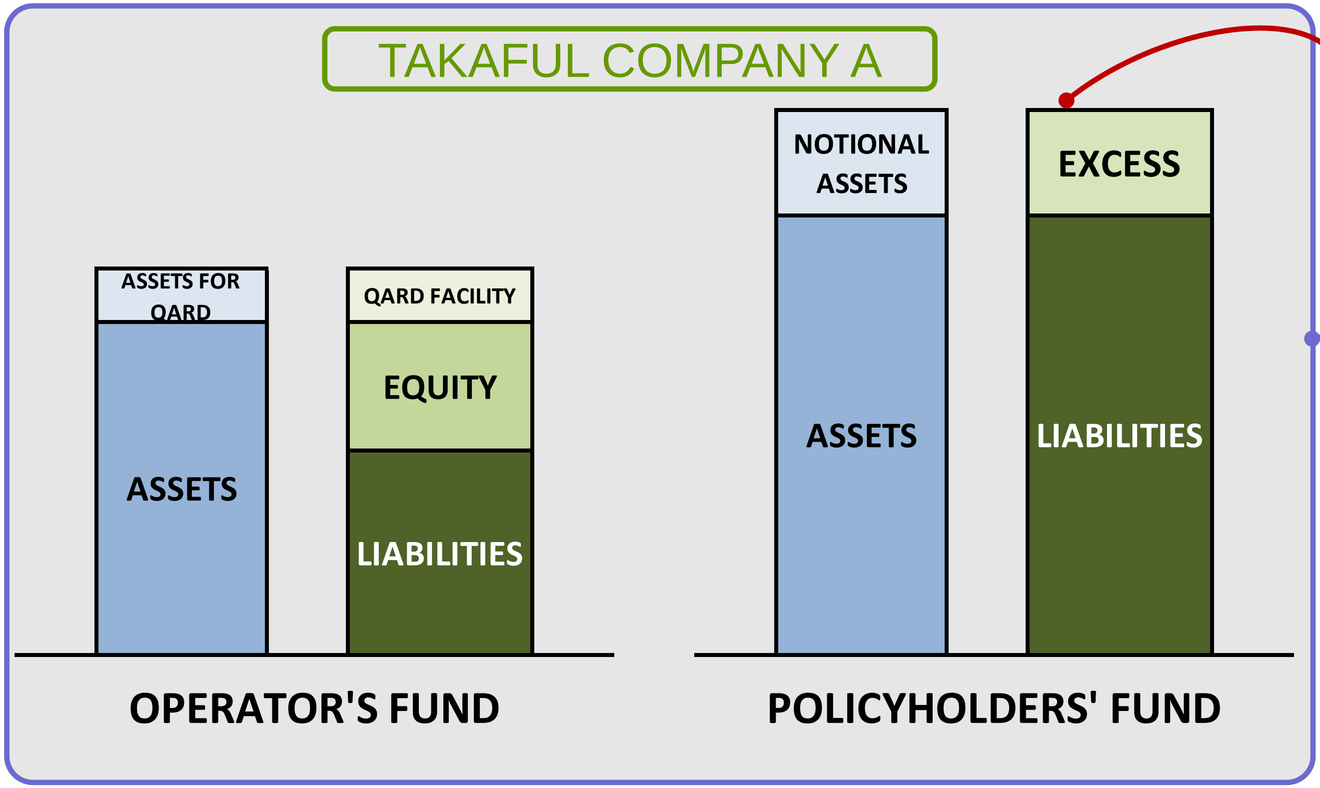
[2] No regulatory obligation to provide Q'ard Hassan but always part of the contractual agreement

Great variance among national regimes provide scope for regulatory arbitrage

Impact of Regulation on FSR 1/2

IN A WEAK REGULATORY ENVIRONMENT

1. Permanence of Qard Hassan is uncertain
2. Policyholders do not have seniority over other liabilities
3. Unclear as to which legal system will apply in case of insolvency



First level analysis on PH fund to ensure sufficiency of funds

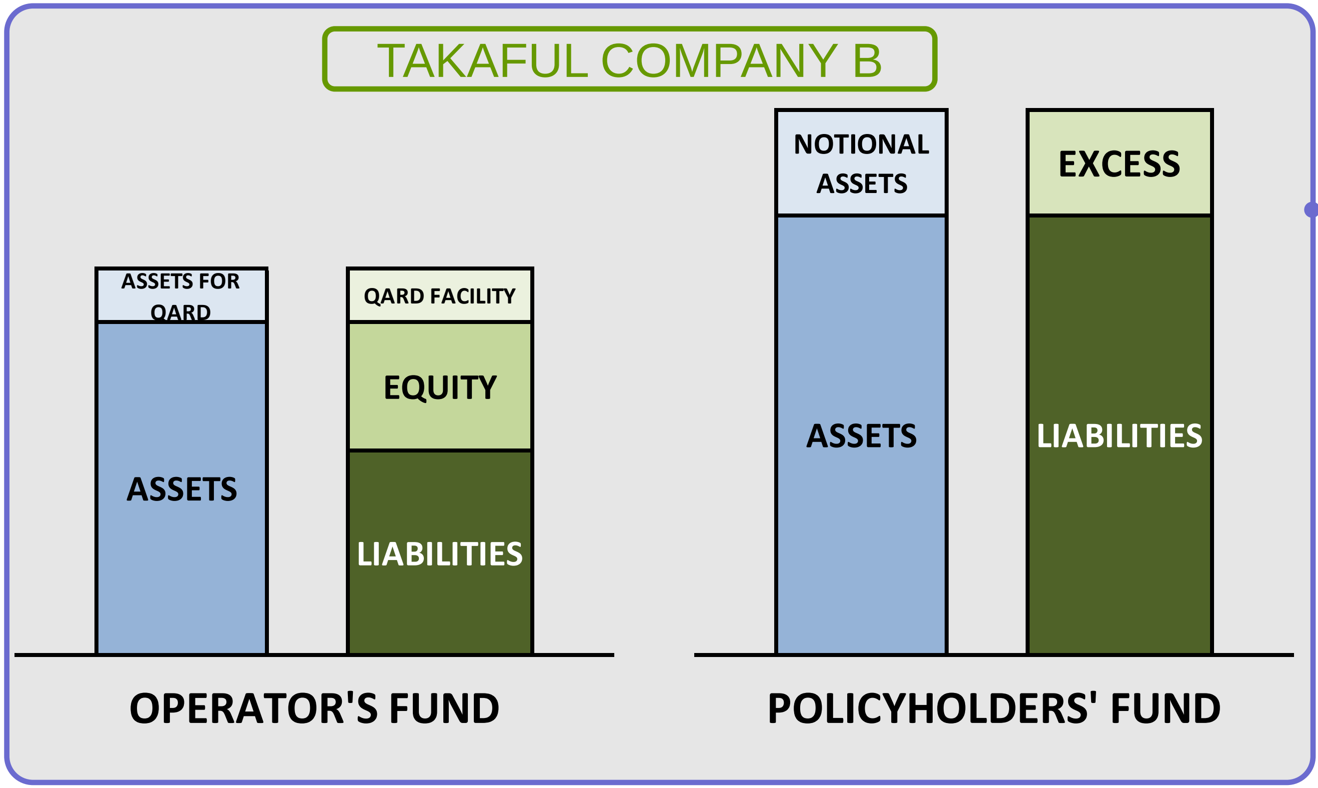
Second level analysis on whole company to establish FSR

In weak regulatory regimes the need to ensure policyholder protection means greater emphasis on viability of PF

Impact of Regulation on FSR 1/2

IN A STRONG REGULATORY ENVIRONMENT

1. Rules regulating Qard Hassan are clear and funding is permanent
2. Policyholders rank senior to all other liabilities
3. Clarity of legal framework in case of insolvency



ONE LEVEL OF analysis on whole company to establish FSR

In strong regulatory systems the policyholder protection rules are the bedrock of the regime

Mitigating Actions to Ensure PH Protection

Insurance companies operating in weak regulatory regimes can improve policyholder protection by:

1. Incorporating the missing regulatory rules in their policy wording e.g. clarifying rules and permanence of their Qard Hassan

2. Ring-fencing assets within Operator's Fund for future use as Qard Hassan

3. Ensuring sufficient surplus is built into PF in its early years of operation

Mitigating risks of weak regulatory regimes is possible but incurs additional costs and reduces fungibility of capital

Conclusion

- Regulation is critical to the rating prospects of insurers in general and of Takaful companies in particular
- There is great variance in the regulatory provisions for Takaful companies
- While similar variance in regulation applies to “traditional” insurers, the Takaful industry can ill afford it given its nascent stage of development
- Strong regulatory regimes provide better policyholder protection, thus ensuring the long-term viability of the industry
- Mitigating factors come at a cost which most operators are loath to accept

THANK YOU

Q&A