

Takaful Business Models - Wakalah based on WAQF

Shariah and Actuarial concerns and Proposed Solutions

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1. Scope

- 1.1** The primary scope of this paper is to highlight some refinements suggested by Mufti Taqi Usmani (Darool Uloom, Karachi) relating to the Wakala model in use by various operators. Mufti Taqi Usmani is very well known in the world of Islamic finance and on the Board of a number of such institutions in many countries. The model has been implemented with a Takaful company in Pakistan as well as being implemented in developing a Family Retakaful solution with a European reinsurer.
- 1.2** The paper also highlights some concerns relating to the different takaful models prevalent amongst the International Takaful operators. The concerns expressed relate primarily to Shariah issues although some Actuarial concerns have also been discussed which came to mind during the discussion process with Shariah scholars. Proposed solutions to these concerns have been expressed for further discussions. A separate Annex 1 is also attached relating to the issue of Sharing in underwriting Surplus by a Takaful operator.

2. Background

- 2.1** The current trend in the financial sector is towards introduction of Islamic financial products by conventional companies as well as setting up of separate companies for this purpose. A number of such products require that the assets be insured through an Islamic Insurance company if one is available. Moreover there is a large potential market which does not insure its assets or take personal life insurance for religious reasons. At the moment, except for one, all insurance companies in Pakistan (total of 48 companies) are based on Conventional Insurance practices and there is a real need for at least a few Islamic Insurance companies in the market. Only one General takaful company has recently started its operations on a limited scale so far.
- 2.2** The awareness of the concept of Takaful is increasing in Pakistan with some of the existing as well as new players considering launching of Shariah compliant products. This is the beginning of signs of a great change where Shariah compliant insurance solutions could finally be available to a population of about 145 million Muslims in the country.
- 2.3** To avail this opportunity to identify Pakistan as a potential market for Takaful operators, I have taken the liberty to highlight the market potential for setting up a Takaful based company in Pakistan. This is done at the end of the paper (Annex 2) after the main scope of this paper has been covered.

3. Takaful Business Models

- 3.1** An increasing need was being felt from many circles in the country for quite sometime relating to an alternative solution to the insurance needs. The growing interest in this area and the global growth of takaful as an alternate system and the opportunities that appear to be increasing in Pakistan, it was felt necessary to explore in detail the basis of takaful systems prevalent in various countries with Scholars in Pakistan for possible implementation.

- 3.2 Some informal presentations and discussions were held at Darool Uloom, Karachi with some potential sponsors as well as individuals managing insurance companies with an interest in the Takaful system. The basic concept of Takaful system and the different models prevalent in other countries were presented to Shariah scholars including Mufti Taqi Usmani, who is very well known in the world of Islamic finance.
- 3.3 This was followed by a Ijma meeting of over 40 Shariah scholars which was organised by Darool Uloom, Karachi. This included scholars from different institutions in the country as well as from Bangladesh and Dr. Abdul Sattar Abu Ghudrah from Middle East.
- 3.4 The Ijma gathering discussed the Mudaraba and Wakala Models and identified some concerns Scholars had with regard to each of these models. As a result of these discussions a **refinement of the Wakalah model was evolved based on the concept of a separate entity of WAQF fund.**

4. Objective of Presenting the Model

- 4.1 It may be mentioned here that my role in the Ijma and subsequent meetings was to convey the Actuarial principles and Operating practices to Shariah scholars and to try to fill the understanding gap where required relating to the basis and technicalities of conventional Insurance business as well as basic Takaful models in practice.
- 4.2 The solutions offered by the Ijma gathering in the form of what is being referred to as "Wakalah with WAQF" have been identified with a brief description and flow diagrams for understanding the refinements made.
- 4.3 My objective in presenting this paper is to seek comments from practitioners in the Takaful World (with only one Takaful operator with 41 conventional General and 6 life insurance companies and over US\$500 million in combined annual premium).
- 4.4 It is highly important to build up on a consensus model from the beginning else people would lose trust in the system itself due to its various interpretations. My fear is that when consumers would raise the issue with Shariah scholars before buying specific products, and well respected and recognized Shariah scholars are not on Board with certain models, that's the beginning of the end of this new system which holds high hopes for the consumers at large who prefer not to insure themselves (especially in the case of personal lines insurance) at all unless legally required.
- 4.5 No model can be assumed to be workable unless practitioners raise practical issues which can then be further raised with Shariah scholars for clarification, guidance and appropriate solutions. The ultimate goal being to evolve a consensus based Takaful model where the Shariah concerns can be minimized so that the consumer has greater confidence in a uniform Takaful model as an alternative system. If the proposed refinements offer a slightly better solution with not much complexities in implementation, it may be tested in other countries as well considering local Shariah as well as laws etc. If it resolves some Shariah concerns and makes it more acceptable around the globe it would be better for the takaful

system as a whole. As mentioned in the beginning, the model has been applied in the context of the first General takaful company set-up in Pakistan and is also being for a Retakaful solution being developed for family takaful with a European reinsurer.

5. Basic Principles

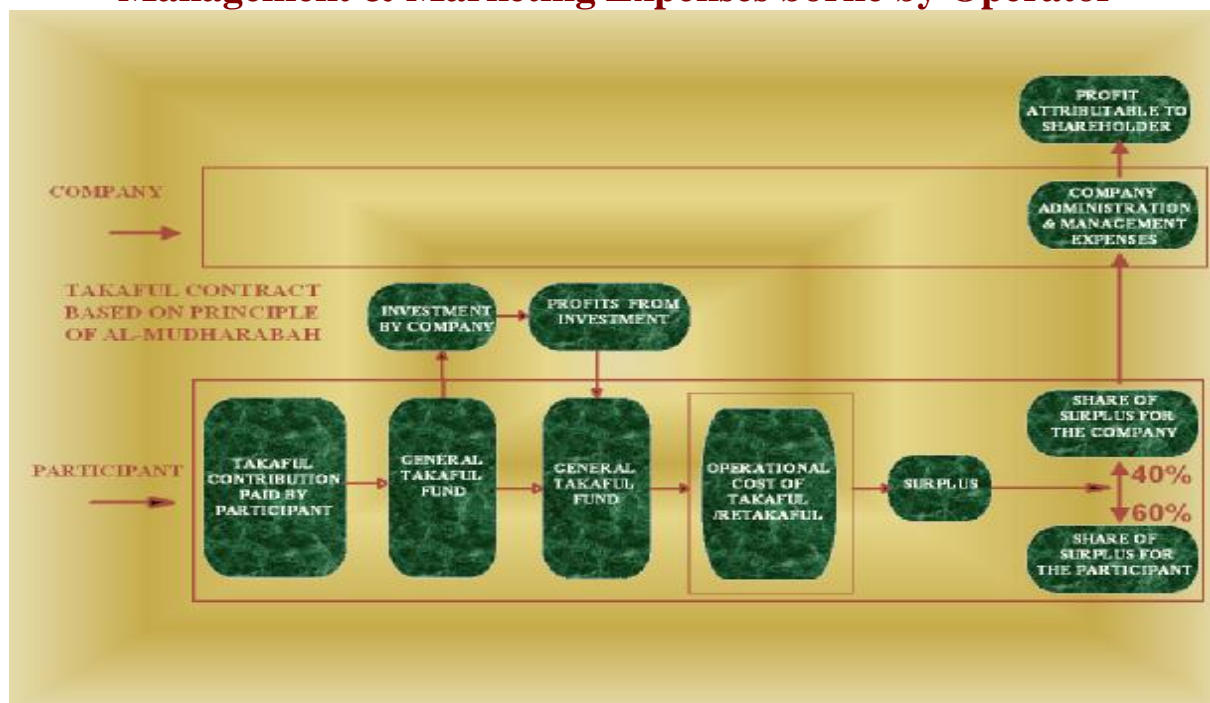
- 5.1 Insurance as practiced by conventional insurance companies is not permissible under Shariah. Mutual Insurance where participants themselves are the owners is permissible.
- 5.2 Insurance system should be based on the concept of “Pooling of Risks”, with a professional services manager charging a fee for his services and not making a commercial gain from the insurance activities. Profit for shareholders therefore should be from “Risk Management” and NOT “Risk Taking”.
- 5.3 In a pure sense, deficit in a pool should be shared by the participants. However there are practical limitations in being able to do so and solutions need to be thought on possible ways to ensure that participants would have the comfort of being able to get their benefits and the Shariah compliance aspect is also fulfilled.
- 5.4 Contract should be based on the concept of “Tabarru” as Gharrar is acceptable in Tabarru and Not in a “Contract of Compensation”.

6. Prevalent Takaful Models

- 6.1 There is enough material available on the basic takaful concepts as well as the different models and differences with conventional insurance. It is important to try to differentiate between the different alternative models being followed in different parts of the world and the concerns that Shariah scholars have raised. This would help to analyse the proposed refinements in the light of these concerns as to whether they address these fully or partially or offer a somewhat better solution from a Shariah perspective. This may lead to further questions and clarifications which is desirable at this stage of development of the takaful system.
- 6.2 Also it is important to note that the basic variations relate to the application of the model to the underwriting “**RISK**” portion and not the investment portion where a Mudaraba approach is generally applied under most models. Blending of models and inclusion of other Shariah permitted contracts/ elements also exist in different contracts. Further variations between different practice models followed by different operators relate primarily to charging of expenses (marketing versus administration) and the fee structure/basis, especially with regard to sharing in the underwriting profits as an incentive for the operator.
- 6.3 **Mudaraba Model**
 - 6.3.1 A flow chart showing the Mudaraba model (also generally referred as the Malaysian Model) for General Takaful is given below for ease of explanation and referencing in highlighting the Shariah concerns:

MUDARABA MODEL

Sharing in UW Surplus and Investment Management & Marketing Expenses borne by Operator



6.3.2 It may be seen here that the participants contributions and investment income is being used to pay for claims, retakaful/reinsurance costs and other claims related expenses from the General Takaful Fund. The overall surplus in the takaful fund is then shared between the participants and the Shareholders in a defined proportion (60:40 here). The Shareholders are responsible to meet all management and marketing related expenses (although there can be variations on charging of marketing expenses) from their share and any remaining amount would be the shareholders profits.

Concerns:

6.3.3 **First** the relationship between the participants is that of Tabarru (donation) by definition of the contract and not of Mudaraba (profit sharing contract). It is therefore of concern to Shariah scholars that “Profit Sharing” contract should not be applied here as donation cannot be Mudaraba Capital at the same time.

6.3.4 **Second** in a Mudaraba contract, a profit is to be generated to be distributed. An investment on a Mudaraba basis of 100 should at the end of the period give more than 100 to be termed as Profit and for the operator to share in that. Profit is not the same as “Surplus” (excess of

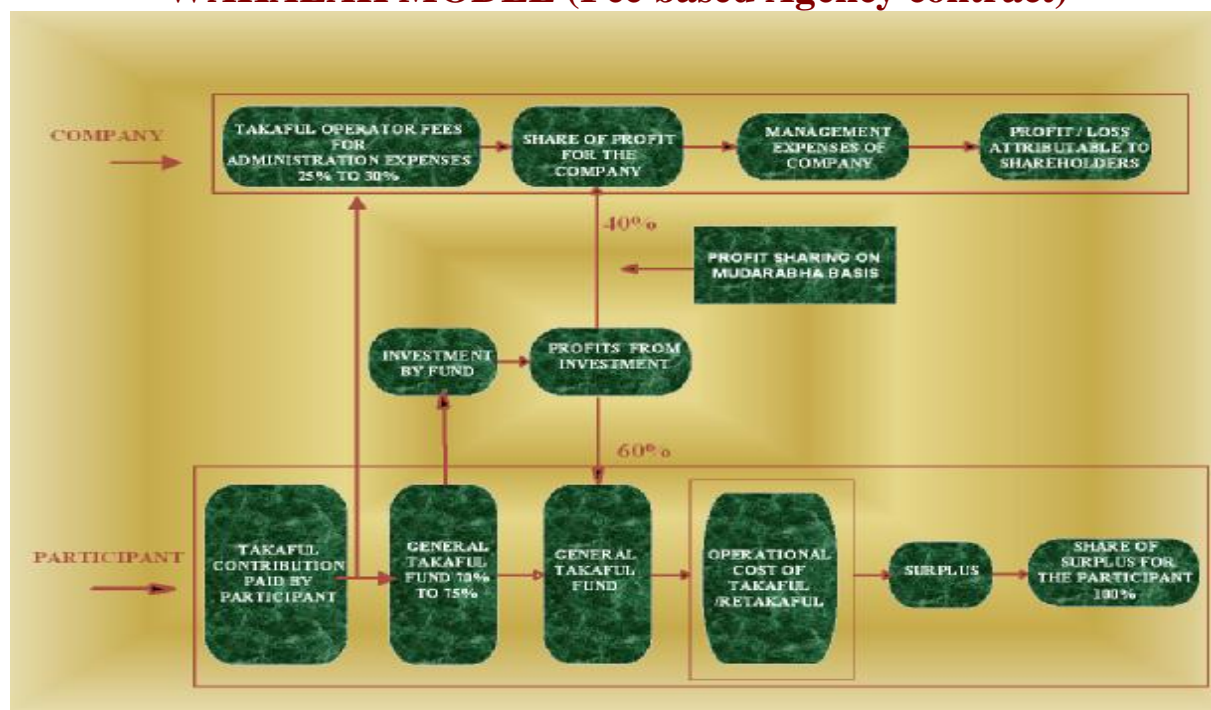
premiums over claims, reserves and expenses) and in the insurance context no profit can be generated by definition so the question of distribution of profit is of concern.

- 6.3.5 **Third** the sharing in underwriting surplus makes the contract essentially the same as conventional insurance contracts where the shareholders become “Risk Takers” and therefore bear the risk and return from the underwriting results just as any ordinary business venture and not a contract for mutual assistance with a fee charged by the operator which may be termed as “Risk Managers”.
- 6.3.6 Fourth the requirement to provide Qard Hasnah (in case of a deficit) in a Mudaraba contract by definition is against the concept of Mudaraba (even if this was a Mudaraba) which is a profit sharing contract and a Mudarib cannot be a guarantor.
- 6.3.7 Finally, it is understood that there is a recognition that the application of the Mudaraba approach to Risk Sharing does not seem to be correct and most new operators are applying the Wakala based model as far as Risk Sharing is concerned (especially in the case of General Takaful and Group Family Takaful type contracts where the investment element is not a part of the contract), even in Malaysia.

6.4 Wakalah Model

6.4.1 The model is common in the Middle Eastern countries as approved by their Shariah scholars. The basic concept here is that the takaful operator acts as a Wakeel for the participants. His role being to manage the affairs of the pool for a defined fee. The flow chart is again given below for ready reference in understanding the concerns:

WAKALAH MODEL (Fee based Agency contract)



6.4.2 The Wakala fee may be defined upfront (generally in the range of 20 to 35% of the contributions) which may be transferred to the Shareholders account. The remaining portion of the contributions may be transferred to the Takaful account which is used to pay claims, retakaful costs etc. The surplus which remains may then be allocated 100% for the benefit of the participants. Generally a portion of the surplus may be retained as a contingency reserve and the balance may be distributed to participants in proportion to their contributions (to those who have not had a claim with other methods also applicable). In case of a deficit, the shareholders would be required to give a Qard Hasnah to the participants to pay for the deficit (as recovery from participants may not be practical) which may be returned from future surpluses (should these arise). The shareholders would be responsible for all expenses of management and marketing etc (variations exist) and their earnings would come from expenses being less than the fee and the investment income share as a Mudarib for the takaful fund and investment income on the Shareholders funds.

Concerns:

6.4.3 The two concerns highlighted below (Incentive fee para 6.4.4. and Risk Premium para 6.4.6) need to be discussed at greater length with practitioners and with Shariah scholars to clarify the approach that is being adopted in practice and its implications.

Incentive Fee related to underwriting surplus

6.4.4 A basic Wakala model is the most widely acceptable form for Risk Sharing contracts. Differences in opinions do still exist relating to charging of expenses (marketing versus administration) and also the fee structure/basis.

6.4.5 One major issue which is still being deliberated upon relates to the pure Wakala model (where the operator charges a fee for services) and modified approaches where within a Wakala model a percentage share of the underwriting surplus is paid as a performance incentive for the operator. Sharing in underwriting surplus is something that does not appear to be in line with the concept of mutual assistance and hiring of professional expertise of "Risk Manager" although it may be argued that it is meant to provide an incentive to the operator to "better manage" the risk. One may argue that as a Wakeel and trustee the operator is responsible to ensure careful and fair management of the takaful fund for the fee that it is receiving. Moreover, better underwriting results through careful risk selection and management would ensure that higher surpluses arise in the takaful fund for distribution to participants. Higher surplus distribution in itself is an incentive for the operator as more clients may get attracted to it due to its better "Risk Management" capability. This would be an indirect benefit of better management and not a direct one which seems more acceptable given the principles of takaful and also the concerns relating to the Mudaraba model where underwriting profits are shared. A detailed note related to this issue has been compiled separately (Annex 1) and the view of prominent Shariah scholars in this regard is that any sharing in surplus by way of an incentive is not permissible.

"Risk Premium" (for claims) and Operator Fee

6.4.6 Another concern relates to the Wakala operator fee being charged to the Takaful fund which I understand from some operators is expressed as a fixed percentage of the total contributions. This is basically as the operator is the Wakeel of the whole fund on behalf of the participants so his fee is based on and recovered from the takaful fund.

- 6.4.7 My concern stems from the way commercial insurance contracts are generally priced and the effect that a fixed percentage fee might have on the takaful fund “Risk Pool” in relation to the Risk that the fund may bear.
- 6.4.8 The typical contract has a “Risk Premium” to which one may add Expense margins and profit margins for the operator. Both the expense and profit margin would need to be competitive based on the volume of premium for a single contract. Identification of these separately is not required in a conventional insurance contract as Expense surplus as well as Underwriting Risk surplus both belong to the Shareholders. However in the takaful system based on Wakala, the underwriting surplus belongs to the participants and therefore adequate risk premium needs to be identified separately.
- 6.4.9 As an example if CLIENT A has say one motor car to be insured and the risk premium rate is 4% of sum assured. Add to this a 30% of gross premium as margin for expenses and profits takes the gross rate to 5.71% $[4\% / (1-.30)]$. NOW, take another corporate CLIENT B who has a fleet of 100 cars to be insured given to its different employees. The actuarial risk premium rate of 4% under the two contracts does not change. What changes is the expense and profit margin which should be much lower in a large contract due to greater competition as well as due to real reduction in expenses and profit objective. Suppose this was just 15% so the gross rate to be charged would be 4.71% $[4\% / (1-.15)]$.
- 6.4.10 IF, a operator fixes the fee as 30% and suppose Client A and B is the total portfolio (101 motor cars) of the operator. The total premium (assuming a unit of 1 for sum assured), would be:

CLIENT A:	5.71×1	=	5.71
CLIENT B:	4.71×100	=	471.00
TOTAL PREMIUM		=	476.71
Less OPERATOR FEE 30%		=	143.01
RISK PREMIUM FOR CLAIMS		=	333.70 (FOR 101 CARS)
RATE % PER CAR ACHIEVED		=	3.30%
ACTUARIAL RISK PREM. RATE		=	4.0%

- 6.4.11 WHEREAS, the risk premium rate for undertaking the risk for the takaful fund should have been 4%. What has happened is that while pricing and attracting clients, we gave a discount to be competitive but when charging the fee to the Fund, the fixed percentage fee being removed may imply that the takaful fund may be left with less to pay claims (3.30%) in relation to the risk being undertaken (4.0%).
- 6.4.12 FURTHER, there are situations where due to the importance of certain clients / businesses for the company, a operator may give an extra ordinary discount to get the business in. Here again an overall fee would mean what is left in the takaful pool for claims would get reduced. This would mean the equity amongst individuals in the “Risk pool” may get disturbed as

more risk is passed into the pool by larger clients than the appropriate risk premium due to the removal of the fixed percentage of contribution as operator fee.

- 6.4.13 This aspect may be visited by practitioners who may very well have devised mechanisms to ensure that this may not happen. However, if this is not the case than there is a concern that depending on the portfolio mix of the operator, the underwriting results could fluctuate. In cases where the major portion of the portfolio is reinsured to a large extent, this risk may get transferred to the reinsurance pool (assuming at least similar levels of commissions are payable by the reinsurer as the operator fee) but nevertheless the risk premium issue remains which would ultimately get reflected in the takaful fund.
- 6.4.14 If this issue does exist, perhaps a solution may be to define at the stage of pricing the appropriate “Risk premium” for the particular risk. For the expense loadings, a operator may have a percentage fee table based on premium size etc possibly with different tables for different lines of business with the flexibility of taking business decisions to reduce fee levels as suitable to a particular case/client.
- 6.4.15 Discussion with Shariah scholars on the above two concerns needs to be with a full explanation of possible outcomes of different scenarios to get a clear response.

Shariah concerns relating to Wakala Model

- 6.4.16 Although Shariah scholars agree with the conceptual basis related to the basic Wakalah model they have expressed some concerns and also proposed solutions which may better address these concerns. The issues have been highlighted here primarily to identify the concerns as per my understanding. I may not have been able to communicate the concerns of Scholars in the most appropriate manner as it requires a much greater level of understanding of Shariah concepts. Clarifications if desired can and should be requested from Shariah scholars as we are in the process of evolution of this system in the hope that what evolves is better than what exists:
- 6.4.17 (i) Under a typical Wakalah model, the tabarru (donation) remains the property of the participants unless consumed as he has the right to receive the surplus back and therefore becomes a conditional gift.
- 6.4.18 (ii) Further this gives rise to issues such as Inheritance (not possible to measure share of surplus in the pool at time of death) and Zakat in the case of death of the person as the donation is a conditional gift.
- 6.4.19 (iii) The relationship is between the participants and the operator and also amongst the participants (exchange of gift for a gift). This also creates doubts about the contract becoming a contract of compensation.
- 6.4.20 (iv) Qard Hasnah is an obligation on Shareholders which would be returned by future generations which would be different from those which may have given rise to the deficit as the participants keep changing on a continuous basis.
- 6.4.21 (v) Contingency Reserves may not be equitable between generations as the operator is likely to also hold higher proportionate reserves in the early years for future contingencies. Since the participants again keep changing on a continuous basis, it leads to an intergenerational

equity issue. In a pure pooling arrangement, one should be able to call on members to actually contribute more in case of a deficit on a pro-rata basis. This is not seen as practical in retail commercial insurance and therefore alternative solution may be explored.

6.4.22 (vi) Wakeel should not be guarantor of the participants whom he represents.

6.4.23 These concerns were considered to be less serious and it was proposed to look for solutions to these issues within the Wakalah model as in principle this model was seen as well accepted by most scholars from a Shariah perspective. The proposed refinements are discussed next referred to as “Wakalah with WAQF fund”.

7. Wakalah with Waqf Fund

7.1 As mentioned in the beginning a discussion on the Wakalah model lead to the concerns related to the Wakalah model and solutions were offered by Darool Uloom Karachi in the form of a Wakalah Model with a separate legal entity of WAQF in between. I have tried to express the understanding obtained and regret any communication gaps which may have resulted due to my expression of the proposed refinements. These can perhaps only be removed by direct discussions with scholars or a review and confirmation process.

WAQF fund - A Shariah Entity

7.2 A Waqf Fund is a well recognized Shariah entity which has been in existence since the days of the Prophet (pbuh). WAQF rules do exist in most Muslim countries. There are three kinds of Awqaf in Islam: Religious Awqaf, Philanthropic Awqaf and Family Awqaf. WAQF may be set-up as a separate Shariah entity which has the ability of accepting ownership or making someone the owner of any asset. The WAQF entity may be registered if there are no legal issues else this is not required. The objectives of the Waqf fund would be to provide relief to participants against defined losses as per the rules of the Waqf fund.

7.3 Many examples of cash WAQF funds exist for instance to give interest free loans, or money given to manage where the returns may be used for social benefits as defined by the WAQF rules. The fund may be managed on a commercial basis for a fee by a fund manager or administrator appointed for this purpose. I understand that Islamic Development Bank also operates several WAQF funds for different social purposes.

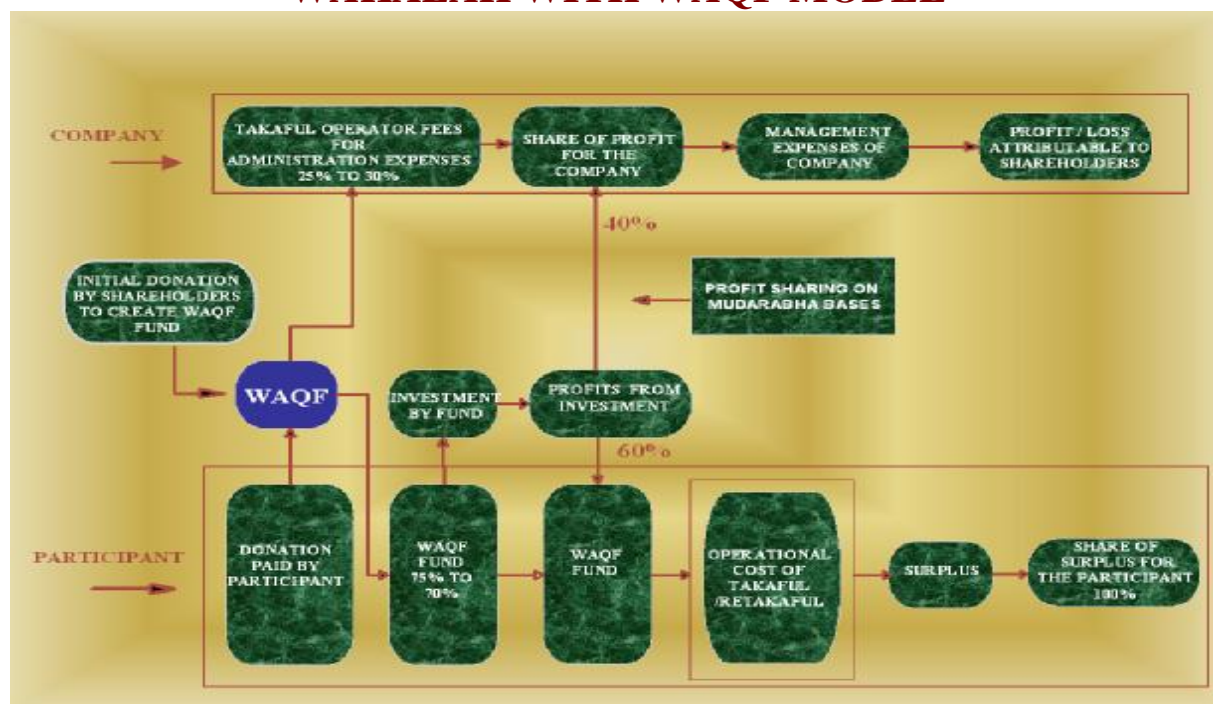
7.4 A conventional insurance contract is a contract between two parties where there is a offer and a acceptance and therefore a Aqd-e- Moawza. The shareholders become the owner of the premiums against which they take on the obligation to pay claims. Where as in the case of WAQF, the tabarru becomes a part of the WAQF fund which becomes the owner and not the operator.

7.5 In a typical wakala contract, the tabarru or hiba is not complete as it is conditional on being used to pay claims and there is a element of surplus which may come back to the participants. From a Shariah perspective proportionate ownership therefore remains of the participants to the extent of the funds not utilized for claims.

Initial Donation

- 7.6 The Shareholders would initially make a donation to establish the Waqf Fund. The donation can be of any reasonable amount (Shariah scholars may specify such an amount). After the creation of the Waqf fund the Shareholders would loose their ownership rights on the Waqf fund. However, they will have the right to administer and develop rules and regulations of the fund.
- 7.7 The original donation of the WAQF fund needs to be invested in a very safe Shariah compliant investment and its returns would be used for the benefit of the participants. The idea being that the WAQF fund should remain intact with high likelihood.
- 7.8 For different lines of takaful services (or different types of risks), more than one Waqf fund can be formed with the share holders money to form a Waqf fund further allocated into different portions to form separate Waqf funds for different lines of takaful services.
- 7.9 A WAQF based model flow has been illustrated below:

WAKALAH WITH WAQF MODEL

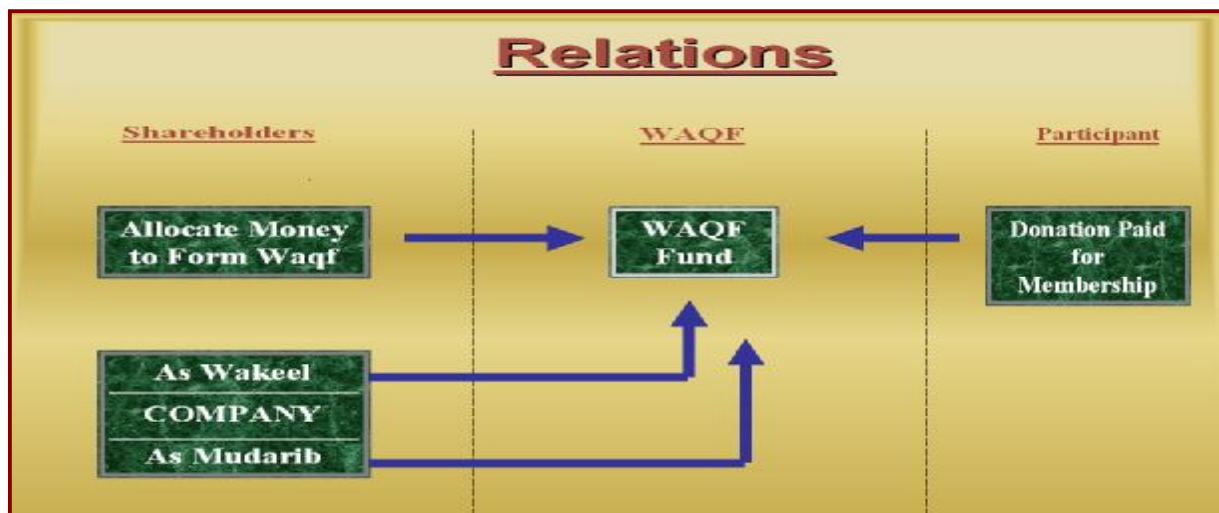


Relationships

- 7.10 In this modified Wakala Model with Waqf, the relationship of the participants and of the operator is directly with the Waqf fund. The Operator is the Wakeel of the Waqf Fund and the participants pay one sided donation to the WAQF fund (not conditional) and becomes a

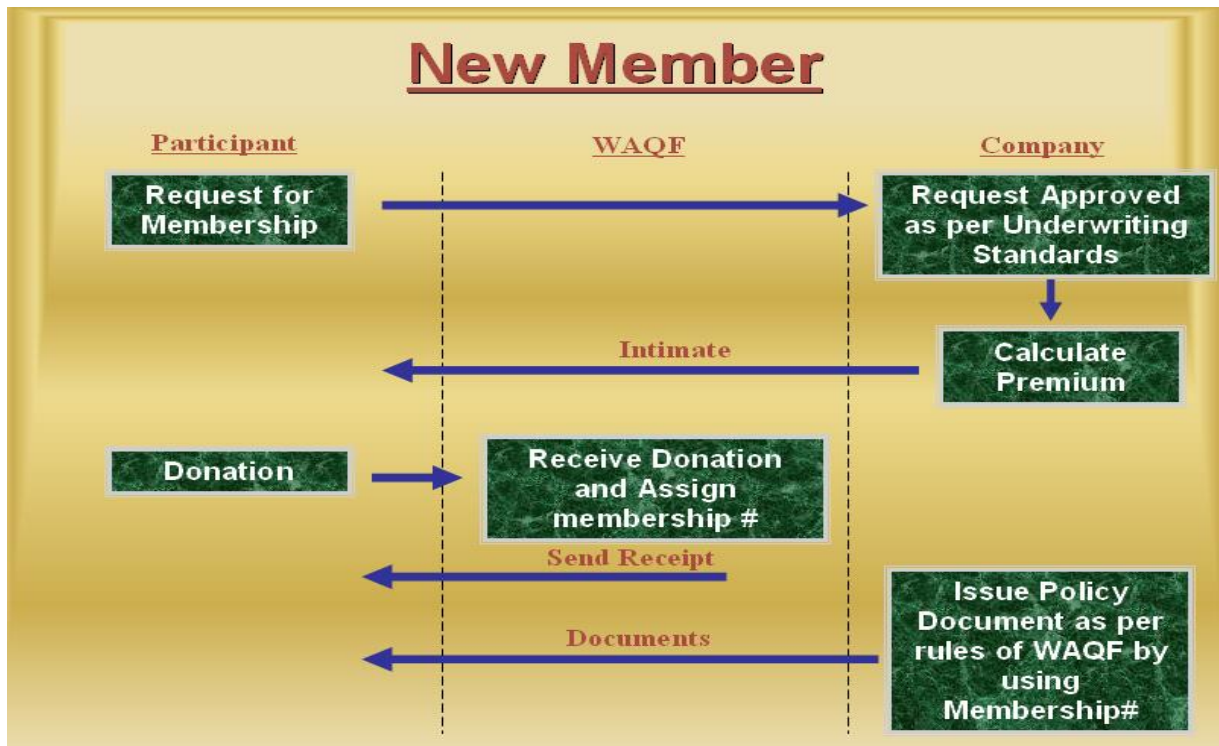
member. This also takes care of the doubt expressed relating to the possibility of Contract of Compensation under a typical Wakala model which leads to the issue of Gharar.

- 7.11 In addition to the relation of agent with the waqf, the company also has a relation of mudarib, when it invests the waqf fund as mudarib.



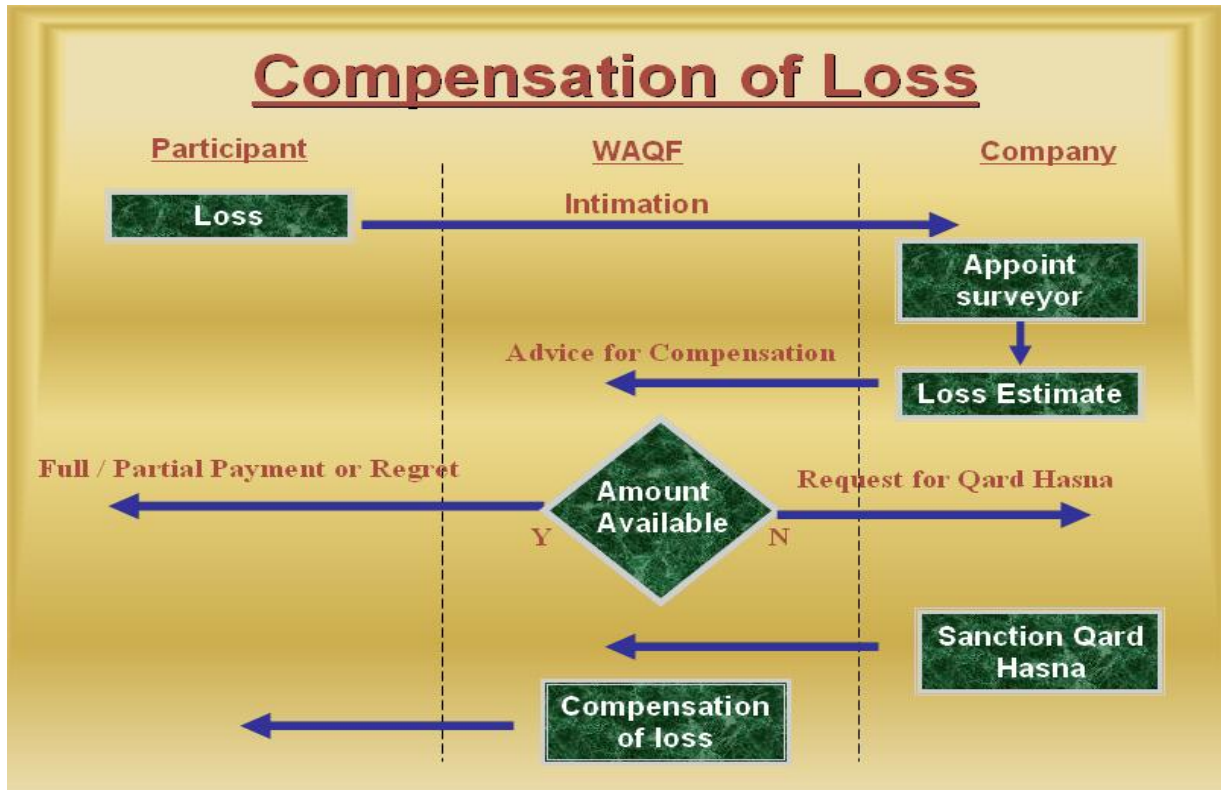
Donations

- 7.12 The donations received from the participants, seeking takaful protection, would also be a part of this fund and the combined amount will be used for investment and the profits earned would again be deposited into the same fund. As per WAQF principles, a member (donor) can also benefit from the WAQF fund.
- 7.13 Company would take this donation on behalf of the Waqf fund as administrator of the fund and deposit this in the fund. The ownership of the participants (donors) would be lost as soon as they pay donation to the Waqf fund and would become the property of the Waqf fund.
- 7.14 The rate of donation would be appropriate to the risk of the participants / assets as per actuarial and underwriting principles applicable.

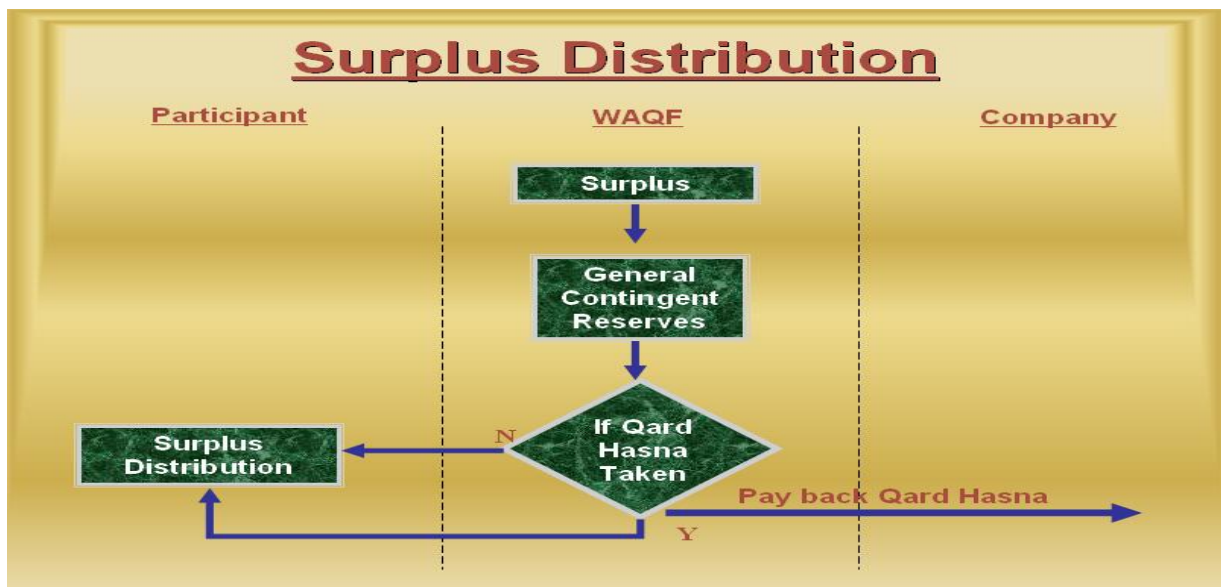


Compensation of losses, Surplus and Qard Hasnah

7.15 The WAQF fund rules would define the basis for compensation of losses to its members and may also define the sharing of surplus and other rules under which it would operate but there would be no obligation to distribute surplus. Besides this, all operational costs that would be incurred for providing takaful services e.g. Re-takaful costs, claims investigations etc will also be met from the same fund.



7.13 Further the Qard Hasnah would be given by the shareholders to the WAQF entity and not to individuals as in the typical Wakalah model. The Shareholders may give a unilateral undertaking to give a Qard to the WAQF fund in order to meet its obligation to its members should there be a deficit. Company would be allowed to recover this loan from the waqf fund over any period without charging any interest.



Reserves

- 7.14 Besides the usual technical reserves such as Unearned premium and IBNR reserves, the Waqf fund would be allowed to form a Contingency Reserve Fund for future situations from the contribution received and the profit earned on the investment.
- 7.15 This reserve would also be the property of the waqf fund and the profit received on it would also be treated as a property of waqf fund.
- 7.16 With the help of this fund Waqf may compensate the current as well as the future participants.
- 7.17 Waqf fund would not need to refund the reserve to the participants at any given period of time.

Sources of Income

- 7.18 The sources of income here would be the same as under the typical Wakala model. The concerns relating to the fee structure and incentive basis expressed earlier apply equally in this case as well.
- (i) Operator Fees: For performing the services, company would be eligible for taking a defined remuneration, which would be paid from the Waqf fund. A deduction can be made from the WAQF fund for this purpose.
 - (ii) As Mudarib by sharing in the investment profits OR as Agent for Investment by taking service charges
 - (iii) By investing the money of the SH and earning profits
- 7.19 From this remuneration, Company would bear the expenses related to the salaries of its employees, rents and other administrative expenses as well as initial expenses related to setting up etc.
- 7.20 The refinements to the Wakalah model discussed above in principle follow the same approach as under a typical Wakalah model but with some refinements in the approach which addresses some of the concerns / doubts that Shariah scholars had identified. It is thought that these refinements address these concerns relating to the Wakalah model and at the same time should not be difficult to implement.

8. Conclusion

- 8.1 Takaful System is still in the process of evolution with a number of concerns and doubts by various Shariah scholars. It is therefore necessary to encourage the process by discussions and alternative approaches that may come from any direction from around the world. The ultimate objective is to have a consensus model addressing as many concerns as possible – current as well as future concerns that may come out. This appears to be a logical way to move forward and ensure that the system at some stage offers a uniform consensus based system.

- 8.2 The Shariah concerns as well as some actuarial concerns in a typical Wakala model have been identified and solutions proposed. The two issues relating to Sharing in Underwriting surplus in a Wakala contract and the issue of Risk premium and Operator fee covered in paras 6.4.3 to 6.4.15 need to be discussed as these can have an impact on the results of the fund and the operator.
- 8.3 The Shariah concerns relating to the Wakala model are addressed by creating a separate WAQF entity in between the participants and the Company. These refinements do not disturb the basic model whereas the result for the consumer does not change.
- 8.4 It is requested of practitioners to consider with their Shariah advisors whether this better addresses the concerns in the typical Wakala model to decide if modifications are suitable in their set-up and may contribute further to the growth of the takaful industry. It is felt that those following the typical Wakala model may at least not have any objections to these refinements as they only contribute a further step in resolving some more concerns and otherwise the same as the typical Wakala model.

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Annex 1

Sharing in Underwriting Surplus by a Takaful Operator in Wakala contracts

The above is a global matter of concern to the takaful industry with some operators following different approaches based on the discussions they have had with their Shariah advisors. The issue relates only to sharing in **underwriting surplus** and therefore different from sharing in investment profits which I understand is clearly permissible.

Given the importance of the matter in ensuring that the principles of Takaful are adhered to, this could be studied in the light of the following arguments given by some practitioners in favour of sharing in underwriting surplus by the operator as an incentive and the counter arguments that I have tried to write down so that a full exposure of the matter could be put forward to you for review.

I am personally of the view that surplus should belong 100% to the participants given the relationship of a “Risk Manager” for a defined fee which should not be based on the surplus in any form. Sharing in surplus would mean takaful would become the same as conventional insurance where shareholders get the underwriting surplus which they also share with the participants in different forms. In fact in conventional the loss goes to the shareholders as well but in takaful the deficit belongs to the participants.

Dr. Abdul Sattar Abughoddah and some other prominent Shariah scholars have expressed the view that sharing in surplus by way of an incentive is not permissible.

Arguments (ARG) and Counter Arguments (CT_ARG) relating to Sharing in Underwriting Surplus by the Takaful Operator:

ARG One:

The primary argument used in favour of underwriting sharing in surplus is that this is an **incentive** to ensure “prudent” underwriting/rating by the operator. If there is no incentive based on the underwriting surplus for the operator and the operators income is derived directly from the defined wakala fees than they argue that the operator would be more inclined to ignore “prudent” underwriting/rating i.e. to say the underwriting standards may be more liberal so as to get more business as the operator would get more fee income by writing more business. This is since 100% of the underwriting results belong to the participants (No sharing in surplus by operator) and therefore any deficit or reduction in surplus would not effect its own income directly (although indirectly it does get affected due to Qard Hasnah and also marketing implication as lower surplus distribution would effect its image as not being a good risk manager).

CT_ARG One:

Argument against this is that the relation between the participants and the operator is that of a Wakeel (trustee) and the duties of the wakeel include “prudent” underwriting.

Incentive should be for something extra i.e. in addition to the normal responsibilities of the operator and should be based on direct work results such as producing more business. Despite most prudent underwriting, the underwriting results of a insurance operation can fluctuate from year to year (in

either direction) due to unforeseen events where the operator has virtually no control. Paying an incentive for better underwriting results implies that the operator would **otherwise not be doing his duty of “prudent” underwriting** for which he is already being paid a wakala fee. If this is appropriate than it seems essential that the operator should also **at the same time be penalized for not being prudent and thereby share in the deficit which may result due to “imprudent” underwriting which often is done due to commercial pressures/business interests.** The sharing in deficit should be direct in the same proportion as the sharing in surplus as discussed further below:

In the case of conventional insurance, the operator may take 100% of the underwriting profits. However at the same time in the case of loss the operator is responsible for 100% of the losses as well. The risks and rewards are therefore totally tied to each other.

However in the case of a takaful operator, one argues for sharing in surplus (to create an incentive to do “prudent” underwriting) but no operator is willing to share in the deficit (which may also arise due to “imprudent” underwriting). The liability of the operator is limited to providing the temporary Qard Hasnah to be recovered from future surpluses.

To be fair, if one has an incentive to do a job better in terms of underwriting results (in addition to being remunerated by a fee) than one should also be penalized in case the job is not done well and results in a deficit in the takaful fund. This should be by being directly responsible for the deficit in a similar ratio as the sharing in surplus and not by way of Qard Hasnah.

Another issue is that once we allow for sharing in underwriting surplus and deficit by the operator, there appears to be no difference remaining between conventional contracts and takaful contracts, except that in conventional this may be 100% and in takaful we may specify a lower percentage which in many cases have been defined as 40% for the operator and at least in one case the incentive is defined as **80% of the surplus for the operator.**

Further in many conventional Group Life contracts the employer gets a share in the surplus commonly referred to as “profit commission” whereby between 30% to 90% (in large schemes) of the surplus from that contract may be returned to the employer. These than appear to be offering a better contract to the employer than takaful would if takaful operator would also be sharing in surplus.

As an illustrative example consider a one year conventional Group Term life insurance contract with a premium contribution of 100. First assume that the claims during the year were 60 and expenses were 20. This leaves the company with a surplus of 20 after expenses (ignoring investment income). This surplus belongs to the company in entirety or the company may share in the surplus under a **profit sharing clause** with the client (which is typically done in Group term life contracts above a certain size). Say the profit sharing was defined as 30% of profits for the client under this contract. So the client gets a profit share of 6 and the company get 14. In total the company gets 20 for meeting expenses and 14 as surplus i.e. 34 from the contract.

- Conventional $100 - 60 - 20 = 20$ UW surplus. $70\% = 14$ belongs to shareholders. 6 is paid as profit share to client.

Now in a wakala based takaful contract, the Wakala fees may be defined as 20% of premiums. Further incentive fees defined as 70% of surplus for shareholders.

- Takaful = 100 – 60 – 20 = 20 UW surplus. Incentive fee of 70%=14 paid to Shareholders. 6 is payable to participants as surplus share.

Here a conventional insurance contract with a profit sharing clause and a Wakala contract with a incentive fee give the same results. In fact conventional gives better protection as in the case of deficit, in the conventional contract the shareholders funds would bear the loss whereas in the case of Takaful Shareholders would give Qard Hasnah which is repayable from future surplus.

Sharing in underwriting surplus is something that does not appear to be in line with the concept of mutual assistance and hiring of professional expertise of “Risk Manager” although it may be argued that it is meant to provide an incentive to the operator to “better manage” the risk. One may argue that as a Wakeel and trustee the operator is responsible to ensure careful and fair management of the takaful fund for the fee that it is receiving. Moreover, better underwriting results through careful risk selection and management would ensure that higher surpluses arise in the takaful fund for distribution to participants. **Higher surplus distribution in itself becomes an incentive for the operator as more clients may get attracted to it due to its better “Risk Management” capability.** This would be an indirect benefit of better management and not a direct one which seems more acceptable given the principles of takaful and also given the Shariah concerns against the Mudaraba model where underwriting surplus is shared. If sharing in surplus is permitted in a Wakala model, the difference between Mudaraba model and even conventional insurance tends to be minimal.

ARG Two:

The second argument is that with similar gross premiums and similar expense levels, conventional companies make money on underwriting surplus whereas takaful operator cannot make money on underwriting surplus. This makes it difficult for them to remain competitive as they may require higher premiums or higher expense charges in order to earn similar returns for their shareholders as conventional companies.

CT_ARG Two:

This does not appear to be a problem as long as takaful operator is permitted to charge a higher wakala fees than the actual expenses. The fee level would be defined and would contain an element of profit for the shareholders which would offset the income that conventional operators would derive from underwriting surplus.

Takaful does not prohibit making money for the shareholders but it defines the sources of earnings for the shareholders to come from the wakala fees element (with an element for profit) and not from the underwriting surplus which belongs to the participants.

ARG Three:

The sharing in surplus was initially not permitted in wakala contracts as per the basic principles of mutuality amongst the participants. However it was later felt that this may result in a competitive

disadvantage from a financial perspective. At the same time it was felt that the real issue when not allowing sharing earlier was the application of the Mudaraba principle to the Wakala contract which was not considered to be correct. However the view now is that it is an **“incentive fees”, being defined in this manner and NOT considered as “sharing in surplus” and hence permitted by some scholars.**

CT_ARG Three:

The counter argument is that the basic principle of mutual benefit under takaful is that the results of the underwriting pool are shared between the pool members. It appears that “sharing in surplus” by way on an “incentive fees” where the end result is that the operator actually benefits from the underwriting results does not appear to be any different from conventional insurance (where the surplus can be considered a incentive for the shareholders in return for risk management) and takaful and also within takaful between mudaraba and wakala models as far as the risk management side is concerned. Also the results of an insurance operation are not purely based on effort but also one of chance events which are not related to the good underwriting performance of the operator. Further as discussed earlier, in conventional insurance the shareholders actually absorb the underwriting loss whereas in takaful the underwriting deficit is passed back to the participants. This in effect would make conventional insurance more equitable as underwriting deficit is fully absorbed by the shareholders (which is a outcome of negative performance). It seems fair that if one gets an incentive for good results (as “performance”) than one should also take the consequences of poor results (as “poor performance”).

It is requested that from a Shariah perspective this issue of sharing in underwriting surplus under a takaful contract needs to be reviewed. There is a urgent need to evolve a global consensus on this issue keeping in view all arguments in favour of and against this very critical issue.

The efforts currently being done to develop takaful by various entities worldwide would otherwise pull in different directions affecting the very credibility of the takaful system itself.

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ANNEX 2 – OPPORTUNITIES IN PAKISTAN**1. THE COUNTRY**

- 1.1 Pakistan is a very large country with a population of over 148 million people of which almost 98% are Muslims. Its economic indicators have shown improvements over the last couple of years and the insurance industry has been showing fairly healthy growth with gross written premiums increasing by 12 to 15% p.a..

2. THE INSURANCE MARKET

- 2.1 The Insurance sector in general is highly underdeveloped in the country in terms of market penetration. Less than 2% of the population is covered under any kind of life insurance plan. On the General Insurance side it is felt that other than the large public sector or private sector listed companies who insure their assets, most small businesses are not insured (other than where mandated by law such as Marine business).
- 2.2 Personal lines insurance such as for personal property, motor vehicles, family health etc hardly exist barring where required by law (for instance in the case of leased cars which has become a very fast growing market) or where provided by the employer such as Group life and Health insurance.
- 2.3 There could be a number of reasons for this low penetration in the Insurance sector, religion being one of them especially on the life insurance side.

3. OPPORTUNITIES**General Insurance (Dec 2005)**

- 3.1 The approximate business figures for the industry for 2005 indicate a total market premium of about US\$300 million (Rs. 18 billion) with about 40 companies operating. The growth in the industry premium has been around 12 to 15% p.a. in the last three years.
- 3.2 National Insurance Company Limited (NICL) underwrites government business with premium of around US\$ 45 million (Rs. 2.7 billion). Some of this business may open to private sector in the near future.
- 3.3 With tighter reinsurance terms due to worldwide events resulting in higher premiums for the industry and ultimately the consumers, consumers are concerned and look for alternative solutions for commercial reasons as well, Takaful being one alternative system.
- 3.4 A fairly significant portion of businesses and individuals do not insure themselves due to non-compliance of the conventional insurance contracts to Shariah principles. More importantly a Takaful company may cater to the needs of Islamic financial institutions, which have currently no option but to insure through conventional means. Further demand is likely to arise from commercial banks, which have been permitted to operate Islamic finance windows. Also leasing companies (especially Car Ijarah contracts) may also provide

potential customers who would like to insure on a Takaful basis. A takaful company will thus complete a vital link in the development of the Islamic financial system.

- 3.5 There is no hard basis to determine the size of the untapped insurance market which would like to insure if a Shariah compliant insurance alternative is available. It is however felt that significant volumes exist for a few takaful operators to come in and survive provided they come with a long term commitment and work with a defined strategy. Personal lines business such as life, health, motor, homeowners, personal accident may have more potential to grow as individuals may have more religious concerns when insuring their personal losses (which are not required and the need is not felt) as opposed to business losses.
- 3.6 To achieve results would certainly require a great deal of effort and dedication in promoting the concept and implementation in spirit. Once a credible operation is established, the volumes should grow exponentially.
- 3.7 The above indicates a sizeable market for General Takaful companies to come up with Shariah compliant solutions for the masses and which should also be commercially viable for those who decide to offer these solutions.

Life Insurance (Dec 2005)

- 3.8 The Life Insurance market has also grown fairly rapidly over the past five years with private sector life insurance companies being allowed to operate in the country. There are six life insurance companies in the country with a total premium income for 2004 of about US\$230 million (Rs. 14 billion). Of this individual life policies account for over 250,000 new policies being issued each year with an annual premium income of US\$38 million (Rs. 2.3 billion). Renewal of old policies for over 2.0 million policyholders accounted for US\$141 million (Rs. 8.5 billion) in annual premium income. Further more than 7.5 million individuals were covered under Group life contracts through their employers paying a annual premium of US\$ 45 million (Rs. 2.7 billion).
- 3.9 The above figures may not seem impressive but indicate a vast potential market where only a very small segment of the market is insured under individual policies. A large segment of the market remains untapped due to religious concerns relating to insurance. Family takaful based on Shariah compliant principles can fill this gap to some extent. Moreover given the relatively low minimum capital requirements in the country and the expanding global takaful industry, the market provides interesting opportunities and challenges.
- 3.10 Group Life insurance contracts are widely used by employers to cover their employees liability related to death and disability. Such contracts covering more than 7.5 million individuals can very easily be offered on a Takaful basis. Most employers however do not provide Group Health coverage, many for religious reasons as well, although the trend of offering this is increasing.
- 3.11 The success of Islamic banks in terms of attracting large amounts of funds on a Shariah compliant basis, clearly indicates a thirst for financial rewards (savings) and protection (insurance) on a Shariah compliant basis. Both these objectives can be achieved through

Family Takaful plans. A number of Islamic banks (local as well as with foreign collaboration) are now under formation to commence operations within a few months which would automatically fuel the demand for takaful products as the Shariah ruling requires that if takaful products are available an Islamic bank / window would need to insure on takaful basis.

- 3.12 After the successful launch of Islamic banking operations by some players, the Government is quite keen to promote setting up of Takaful operators.
- 3.13 Takaful Rules have been notified by the SECP which specify the guidelines under which a takaful operator would need to operate. These include business model permissible as well as investment and operational guidelines etc. A number of conventional players are now considering setting up takaful companies as well.

Need is the mother of Invention. Like any other products, product innovation generally takes place when there is pressure from consumers on the industry to provide alternative solutions. It is therefore the responsibility of the consumer to demand Shariah compliant products if they wish insurance companies to come up with such products. **It is felt that the consumers demand for Shariah compliant products is increasing and there appears to be a reasonable level of demand for operators to come forward.**

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