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Risk Management and Disclosure in Takaful Practices

Dawood Y Taylor

Senior Regional Executive-Takaful, Middle East

Prudential Corporation Asia

An Overview of Risks in Conventional Insurance

- **Financial Risk Types**
  - Market Risk
  - Credit Risk
  - Insurance Risk
  - Liquidity Risk

- **Non-Financial Risk Types**
  - Operational Risk
  - Business Environment
  - Strategic Risk

In conventional insurance, risks are transferred to the insurance operator from the policyholder

Takaful undertakings are both concerned with the above as well as special considerations as discussed in this presentation

Conventional / Mutual Insurance / Takaful Comparison

	Conventional	Mutual	Takaful
Contractual Relationship	Exchange contract between policyholder and company	Risk sharing by policy-holders, within the mutual company	Combination of a Tabarru’ contract and contractual relationship between the participant and company (Wakala and / or Mudarabah)
Responsibility of Policyholder / Participant	Surplus and deficit can be from account of only insurer (e.g. non-par policies) or both insurer and policyholder (e.g. with-profit policies)	Policyholder pays premium to the mutual pool; Surplus and deficit are for the account of the policyholder; Surplus can be retained in reserve to pay future deficit	Participant pays Tabarru’ and, in the case of life Takaful, an element of savings; Surplus can belong wholly to the participant or, depending on the contract, the Takaful operator may participate in the surplus
Liability of Insurer / Operator	Insurer pays claims from its own account (e.g. non-par policies)	Claims paid from the mutual pool	Claims paid from the Takaful fund; in the event of such funds not being sufficient, a Qard Al Hasn would be made available by the insurer
Access to Capital	Access to share capital and subordinated debt	No access to share capital but possible use of subordinated debt	Access to share capital by Takaful operator and Qard Al Hasn
Investment of Funds	No restrictions except those imposed for prudential reasons	No restrictions except those imposed for prudential reasons	Assets are restricted to Sharia compliant funds

Typical Takaful Structure

- **A typical Takaful operation is a hybrid of both a mutual underwriting pool on behalf of participants as well as an Islamic commercial operation belonging to the Takaful operator**

- **A participant makes a contribution (Tabarru') to a common underwriting pool**

- **In Life Takaful, the contribution could also consist of an element of savings or investment that is not considered as Tabarru' or part of the common underwriting pool**

- **Typically, a Takaful operation is managed under a Wakala or Mudarabah model, or under a combination of both**

Risk Overview in a Takaful Operation

- **Fundamentally, Takaful risks fall partly on the participants partly on the Takaful operator**
  - A Takaful operator is NOT exposed to underwriting risks; these are borne entirely by participants
  - All client investments risks are borne by the participant
  - Business risks fall on the Takaful operator

- **Risk in a Takaful operation falls under the following headings:**
  - Underwriting risk
  - Investment risk
  - Governance and operational risk
  - Reputational risk
  - Compliance with Sharia rules risk
  - Business continuity risk

Additional Issues Relating to a Takaful Operation

- **In Takaful, Islamic legal contracts govern relationships with the policyholder**
- **Takaful operator manages operations on behalf of policyholders**
- **Tabarru' is fundamental to all Takaful schemes**
  - Allows forgiveness of uncertainty (al gharrar) inherent in all insurance operations but prohibited under Sharia
  - Conventional insurance includes elements of interest (riba) at all levels, which is forbidden (e.g. interest in the shareholder funds, underwriting funds and savings funds investments)
- **In mitigating risks, Takaful uses retakaful wherever possible**
  - If limited and with Sharia board approval, the operator can use reinsurance until retakaful becomes available

Managing Risks in Takaful

Managing Risk in a Takaful Operation

- **A Takaful Operator is required to manage risk at two levels**
  - Underwriting and investments risks of the Takaful funds and participants' savings and investment funds
  - Fiduciary, Business and Operational risks, to which the operator is exposed as well as the investment risks associated with the shareholders assets

Mitigating Potential Underwriting and Business Risks

- **Managing underwriting risks by undertaking due diligence**
- **Effective management of fiduciary and business processes**
- **Actuarial and investment risk management practices**
- **Liquidity risk management procedures to ensure repayment of claims**
- **Alignment with Sharia and board rulings**

Underwriting Risk

- **Sharia principles relating to equity and fairness applied throughout**
- **All participants treated as "equal" -- ratings may apply**
- **Management of underwriting risks from both a contractual and prudential perspective**
- **Underwriting procedures to ensure operator may decline risks if necessary**
- **Transparency on how the operator would address key issues, e.g.:**
  - Qard Al Hasn
  - Unexpected losses due to misconduct or mismanagement and use of Takaful participants funds
  - Protection of participants' funds in the event of financial distress

Investment Risk

- **Techniques for managing market risk, as used in conventional insurance, subject to Sharia restrictions on investments**
- **Independent pricing group to ensure correct marked-to-market where there is limited secondary market for such assets**
- **Strict rules on the types and levels of assets that can be held in a Takaful fund**
- **Investments in illiquid investments carefully monitored**

Governance and Operational Risk

- **IFSB has published detailed Governance guidelines for a Takaful operation**
  - Available online via the IFSB website

- **These should be adopted to reduce risk in this area**

- **Operational risk covers both the operator as well as the participant**

- **Mismanagement of a Takaful operation can expose the operator to potential financial loss through litigation, fraud, theft, lost business and inefficiently deployed capital**

Reputational Risk

- **Takaful must protect itself from any criticism leveled at the conventional insurance industry and uphold the Sharia rulings applied to the industry**

- **The operator should draw on in-house or external Sharia advisory counsel to review and audit operational dealings to ensure adherence to Sharia standards**

- **The operator should ensure all staff are trained in key business policies and procedures that require observation of Sharia rules and principles**

- **Adherence to customer, anti-money laundering, code of conduct and corporate governance guidelines at all times**

Compliance Risk with Regard to Sharia Rules

- **Very closely associated with reputational risk**
- **Institutionalised compliance procedures**
- **Formal Sharia audit**
- **Corporate governance body reporting to the board**
- **Adherence to local laws and insurance regulations within the Sharia rulings, dictated by the Takaful Sharia advisory board**

Business Continuity Risk

- **Takaful operator needs to develop and manage its business continuity risk**
- **Loss of senior management**
- **Ensuring knowledge sharing, particularly in actuarial science, Sharia interpretation, etc.**
- **Succession planning**
- **Resilience of IT functions**

Concluding Remarks

- **Similar risks across both Takaful and conventional life markets**
- **Takaful may also leverage risk management best practices employed in the Islamic asset management sector**
- **Additional operational risks bring increased responsibilities to the Takaful operator**
- **Risks inherent to the Takaful fund and to the operator may overlap, but controls for each level of risk can be addressed through specific mechanisms**
- **Feed "lessons learned" back into ongoing risk management**

Thank You

Dawood Y Taylor

Senior Regional Executive-Takaful, Middle East

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Dawood.taylor@prudential.com.hk