Insights

GLOBAL TAKAFUL CONTINUES UNBROKEN DOUBLE DIGIT GROWTH

15% y-o-y growth in gobal takaful contributions for 2013 adds another successful year to the industry's continuous double digit expansion since 2009. Forecasts for 2014 predict equally strong growth, while lessons learned from Malaysia's response to some of the industry's pressing challenges could drive the industry to greater heights.

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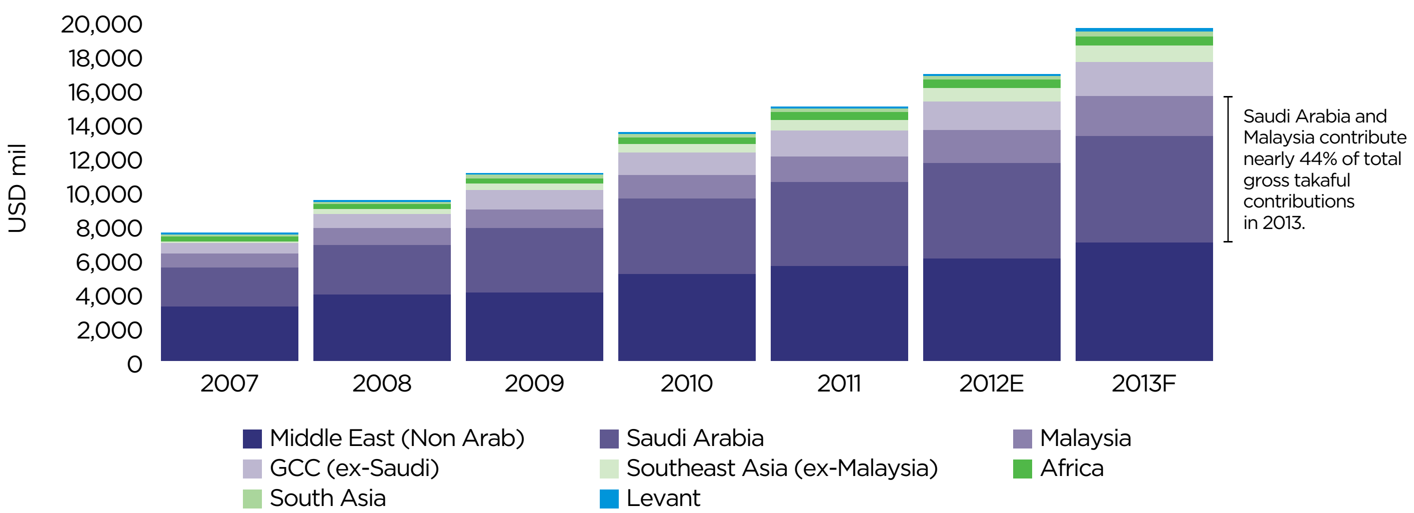
The global takaful industry: sustaining double-digit growth amid challenges in the industry

The global gross takaful contributions are estimated to have amounted to USD19.87bln[1] (15% y-o-y growth) as at end-2013, with Malaysia and Saudi Arabia continuing to drive the sector being the two largest takaful markets[2].

The global takaful industry has experienced strong double-digit growth rates in recent years recording an impressive 18.1% CAGR during the last 5 years (2007-2012). Malaysia and Saudi Arabia continue to drive the global takaful industry in 2013 having collectively generated approximately 43.7% of the global gross takaful contributions during the year. The takaful market in Malaysia, which is served by 11 takaful operators, has maintained its growth momentum over the years and as at end 2012, it is estimated that the gross takaful contributions have reached USD1.93bln, at a CAGR of 18.69% (2009-2012). The amount is expected to surpass USD2.2bln by the end of 2013. The growth in Malaysia is mainly on account of an increasing awareness among the demographics regarding the benefits of insurance/takaful products that have helped boost demand for the takaful sector's products in the country.

Despite the impressive double digit growth rates, the global takaful industry remains a small segment representing a nascent 1.13% share of the global Islamic finance industry as estimated at end-2013. The small share of the takaful segment in the global Islamic finance industry during the last few years is a result of comparatively faster growth in other Islamic

Global Gross Takaful Contributions by Region (USD mlns) Source: World Islamic Insurance Directory, EY, KFH Research Limited



[1] KFH Research Limited
[2] Excluding Iran

finance sectors such as Islamic banking (19.1% CAGR 2007-2012) and sukuk (19.3% CAGR in sukuk outstanding 2007-2012)[3]. Nonetheless, the potential for the takaful segment to expand rapidly and gain market share is enormous given that large segments of the insurance market in key Islamic finance jurisdictions remain untapped and are mainly dominated by conventional insurance providers.

Comparison between Insurance and Takaful

Takaful is the Shariah-compliant alternative to conventional insurance based on the principles of cooperative risk sharing, mutual responsibility, mutual protection, and solidarity among groups of participants. The risk pool is managed by the takaful operator which is run on a commercial basis with corporate responsibilities towards its stakeholders, that is, the participants, employees and shareholders. Takaful products are offered by operators according to two main business lines: family takaful which includes various life, medical and investment products; and general takaful products which provide home, motor, personal accidents, marine and aviation protection products.

	Insurance	Takaful
Concept	• A risk-transfer mechanism	• A risk-sharing mechanism of mutual protection and shared responsibility
Contract	• An exchange contract (sale and purchase) between insurer and insured	• A combination of Tabarru' contract (donation) and agency or profit-sharing contract
Responsibility of policyholders/participants	• Policyholders pay premium to the insurer	• Participants make contributions to the scheme
Liability of the insurer/ operator	• Insurer is liable to pay the insurance benefits as promised from its assets (insurance funds and shareholders' fund)	• Takaful operator acts as the administrator of the scheme and pays the takaful benefits from the takaful funds • In the event of deficiency in the takaful funds, takaful operator will provide Qard to rectify the deficiency. This loan is to be recovered from future underwriting surpluses
Investment of fund	• There is no restriction apart from those imposed for prudential reasons	• Assets of the takaful funds are invested in Shariah-compliant instruments and in a prudent manner

Source: BNM, KFH Research Limited

[3] KFH Research Limited

GLOBAL TAKAFUL CONTINUES UNBROKEN DOUBLE DIGIT GROWTH

As per a report, "Islamic Finance Outlook 2014" by KFH Research Limited, key Islamic finance jurisdictions in the GCC, Southeast Asia and South Asia are characterised by low insurance penetration rates averaging around 1% of the country's GDP with the only exception being Malaysia, which had an insurance penetration rate of 5% as a percentage of GDP. In comparison, jurisdictions such as Japan and Hong Kong had insurance penetration rates of 10.1% and 11.5% respectively. Moving forward, it is forecasted that the global takaful industry will surpass the USD25bln milestone by the year 2015.

The entry of new takaful operators in both existing and previously untapped markets, for instance the inaugral entry of Oman in the takaful business as Oman's first takaful company Al-Madina Takaful commenced operations on 1st January 2014, is likely to drive growth of the takaful sector in the GCC region. Similarly, it is anticipated that Philippines will enter the takaful industry as the Insurance Commission of the Philippines is formulating takaful regulations to enable takaful services in the country. Countries in Africa exploring and expanding on Islamic finance (including takaful) include Morocco, Tunisia, South Africa, Senegal, Kenya, Nigeria and Djibouti and the takaful sector is expected to be part and parcel of this expansion. In Asia, countries such as Afghanistan, Azerbaijan, Kazakhstan, Thailand, Singapore, Maldives, Sri Lanka and others where Islamic finance remains as a niche are also promising markets which could witness expansion in the number of takaful operators during 2014 and beyond, thus contributing towards an expansion of the global takaful industry.

Growth of the sector is also poised on a number of favourable regulatory developments that will spur demand for takaful products. For instance, in the GCC's second largest market, the United Arab Emirates (UAE), a new regulatory law which makes it mandatory for all employers in the country to provide health insurance to employees is bound to boost family and medical takaful segments. Similarly, takaful operators also have opportunities to expand their underwriting market share in the general takaful business lines of fire, property, work-place hazards and casualties, underpinned by tremendous volumes of infrastructural development taking place across the key takaful markets of GCC and Malaysia.

Notwithstanding its vast potentials, the takaful industry faces a number of internal challenges which are impeding its real potential growth rates while affecting the profitability of the operators and limiting expansion of the sector's market share. In this light, the following aspects are among several critical success factors which could drive the industry to greater heights from a growth and financial resilience perspective:

1. **Governance and Regulatory Compliance:**
   At a global level, the Islamic Financial Services Board (IFSB) and the International Association of Insurance Supervisors (IAIS) have established a Joint Working Group (JWG) which produced a paper that grouped the takaful industry's issues under the following four major themes: a) corporate governance; b) financial and prudential regulation; c) transparency, reporting and market conduct; and d) supervisory review process, with the conclusion that these issues should be addressed in an integrated manner. The JWG also identified corporate governance for takaful as one of the priority areas, as it embraces the industry's fundamental issues such as acceptable takaful models and their essential parameters, the relationship between takaful participants' and shareholders' funds, and Shariah governance, among others. The global takaful industry could benefit with consistent regulatory frameworks amongst key markets in order to harmonise practices while enhancing corporate governance. In addition, takaful operators are often left without adequate scrutiny in product governance and offerings. The takaful operators themselves need to ensure they comply with IFSB's standards of best practice and key regulatory guidelines in order to enhance financial resilience and performance. By having common established benchmarks to measure performance and assess compliance, the takaful operators can operate on a more transparent platform while boosting public's confidence that spur further growth.

2. Risk Management and Internal Controls: Takaful operators need to strategise risk management functions and governance, in particular, to embed the need for Shariah compliance risk in all phases of operations and management. Furthermore, takaful operators need to instill an internal mechanism for assessing solvency and ensuring sufficient capital buffers at all times, in particular, to withstand adverse market turbulence and shocks.

survival of the operators. Similarly, insurance regulators in the various takaful markets also need to understand the distinct principles and Shariah-compliant philosophies guiding the takaful industry and as a result, introduce appropriate regulatory and supervisory guidelines for takaful operators to follow in terms of their operational aspects such as product features, distribution approach, statutory reporting and disclosures, and etc.

Snapshot of Malaysia's regulation and legislation for the takaful sector

The Malaysian regulatory bodies have been at the forefront in responding to the pressing challenges surrounding the Malaysian Islamic finance industry and formulated the Islamic Financial Services Act (IFSA 2013), a comprehensive Islamic finance legislation pertaining to all sectors of the Malaysian Islamic finance industry including takaful. In addition, Bank Negara Malaysia (BNM) has introduced various guidelines relating to takaful in a holistic manner ranging from operational to solvency prudential safeguards such as the "Guidelines on Takaful Operational Framework" (TOF) and the "Risk-based Capital Framework for Takaful Operators" (RBCT). The IFSA 2013, which was gazetted as a law on 30th June 2013, and the other guidelines such as TOF and RBCT set out operational and governance aspects, Shariah considerations, risk management, capital adequacy, product governance and other related factors of takaful operations, aiming to overcome the challenges surrounding the growth and efficient performance of the takaful operators. The IFSA 2013's Section 16 (1) critically enforces separation of licences between the general and family takaful segments and provides a time period of five years for existing composite operators to bifurcate between the two segments. This measure aims to achieve a stronger business focus in either family or general takaful for takaful operators while also brings Malaysian insurance laws to be in parallel with international insurance laws. In addition, the TOF Paragraph 10.10 also encourages growth of the retakaful capacity by making it mandatory for the takaful operators to subscribe to retakaful, and only in an event of unavailability of retakaful services should contributions be ceded to conventional reinsurance providers. Meanwhile, the Financial Sector Blueprint (2011-2020) of Bank Negara Malaysia stresses on the importance of developing human capital across all sectors of the Malaysian finance industry, including Islamic finance.

3.Operational and Business Excellence: Takaful operators need to improve on business models and embrace technology in all operational, sales and marketing strategies to achieve cost efficiency and improve productivity. Intense competition globally in some high risk segments such as motor and medical takaful are reducing margins of the takaful operators, thus affecting the returns and

4. Product Governance and Strategy: The takaful sector is in need of developing innovative product lines that could generate new cash flow streams for the operators. For example, it is critically observed that the takaful operators have very low penetration rates in niche business lines such as marine, aviation and transportation[4]. The reasons behind the limited offerings in these business lines are

[4] KFH Research Limited 2014, Ernst and Young 2013, World Islamic Insurance Directory 2013

regarded to be a lack of expertise as well as lack of capacity of the existing operators to venture into such large scale and specialised product lines. The industry also needs to achieve global recognition for its products as alternative options of protection and savings products that could possibly lead to long-term growth of the contributions of the operators. More critically, the industry needs to develop a robust product governance system to ensure that policyholders and customers are treated honestly, fairly and professionally.

5. Shortage of Retakaful capacity / Leakages to conventional insurers:
Retakaful plays an important role in spreading portfolio risk over different takaful pools and provide underwriting capacity that would enable takaful operators to cede larger risks. Currently, there are only a handful of retakaful operators in the industry and leakage to the conventional reinsurance market has posed a major constraint on the growth of retakaful. Several factors for this leakage include risk appetite, pricing, ratings, and long standing relationships with reinsurers; rather than lack of retakaful capacity.

6. Talent and Leadership Development:
There is a critical need for developing appropriate human capital and talent in the near future for specialized skills in areas of underwriting, risk management, and product development including in areas of large and specialised product lines. Takaful operators should strategise talent development and knowledge base and explore personal, technical and professional attributes deeply.

In order to address the challenges surrounding the takaful industry, notable efforts have been exerted by the global multilateral body IFSB to provide standards and guidelines for the takaful operators to adhere to in order to maintain stability in their operations. In addition to the efforts of the IFSB-IAIS JWG in 2006, the IFSB has followed on with a number of standards and guidelines for takaful operators, responding to the dynamic needs of the market in the aftermath of the global financial crisis. To date, IFSB has released guiding principles on governance for takaful undertakings in December 2009; standards on solvency requirements for takaful undertakings in December 2010; guidance notes on the recognition of ratings by external credit assessment institutions on takaful and retakaful undertakings in March 2011; and most recently in November 2012, IFSB released an exposure draft on standards for risk management of takaful undertakings and this is expected to be released soon as published standards.

Conclusion

Saudi Arabia and Malaysia will continue to lead the global takaful segment being the two largest and most developed takaful markets, although in the GCC, growth of takaful sector is anticipated to fall below average global takaful industry growth rates as the domestic insurance market gets very competitive with a large number of players. The Malaysian takaful industry is expected to witness restructuring exercises in the light of the implementation of the Islamic Financial Services Act (2013). Some of the notable changes in the Malaysian takaful landscape would include establishment of new entities as existing composite operators need to bifurcate between general and life takaful entities. The industry could also witness mergers and acquisitions between operators to meet the capital adequacy requirements in the light of the risk-based capital framework introduced by Bank Negara Malaysia in 2012 to enhance the prudence and resilience of the takaful operators. Overall, the Malaysian takaful landscape is on route to achieving more stability and resilience in the near future with the implementation of this new Act.

The global takaful industry has maintained its double digit growth rates over the years and is set to continue its remarkable growth in 2014. It is forecasted that the gross takaful contributions as at end-2014 will range between USD22bln and USD23bln[5]. The growth of the gross takaful contributions in 2014 and beyond are bright on the back of growing awareness among demographics on the benefits of subscribing to insurance/takaful products and the low insurance penetration rates in Muslim majority countries.

[5] KFH Research Limited