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AN OVERVIEW OF ISLAMIC INSURANCE

Conventional insurance involves the elements of uncertainty, gambling and interest, all of which are unacceptable under Islamic law. Muslims around the world have for generations grown up with the mind set that insurance is forbidden because it contravenes some of the Islamic doctrines. However, the 1985 Fiqh Academy ruling declared that conventional commercial insurance was forbidden but insurance based on the application of cooperative principles, Shari'ah compliance and charitable donations, was acceptable. This allowed the creation on a new industry, takaful, offering risk protection and savings products to the world's 1.6 billion Muslims.

Takaful, meaning "guaranteeing each other" in Arabic, is an Islamic system of mutual insurance built around the concept of donation. Each participant contributes to a fund to cover expected claims, while also benefiting from a share of investment returns. There are some parallels between takaful and mutual or cooperative insurance. There must be cooperative principles in takaful, but there need not necessarily be Islamic principles in conventional mutual or cooperative insurance.

The past 20 years have seen takaful operations opening in Islamic countries as well as countries having large Muslim communities. In the Far East, Malaysia has been at the forefront of takaful development. Singapore, Indonesia, and Brunei have also developed takaful operations, and Bangladesh and Sri Lanka are also taking a more active role. In the Middle East, takaful has developed in Saudi Arabia, Bahrain, Iran, and Qatar with new operations recently opening in Egypt, United Arab Emirates, and Kuwait. Steps have been taken in Europe and the US, but these are still very young markets, even compared to the overall emerging global market for takaful. There is no doubt a tremendous opportunity for takaful in those Western countries that have large Muslim communities, but significant investment is required to compete with the conventional insurance industry, and regulatory changes would be necessary, as seen in the Malaysian market, to allow takaful to compete on equal terms.

Estimating its size presents challenges as there is no single body tracks reported premiums for this segment. However, the Institute of Islamic Banking and Insurance has projected that the market will reach $7.4bn in premium by 2015. Growth rates are estimated between 15% and 20% per annum. The potential for Takaful is enormous given that insurance penetration in most Islamic countries does not exceed one percent of gross domestic product. For comparison, in the United Kingdom 12.4% of GDP is expended on insurance whilst the figure is 9.4% in the US.

Takaful models

The two main business models used in the Takaful industry are the Mudharabah and the Wakalah models. The Mudharabah model is commonly used in Malaysia and involves the takaful operator managing the operation in return for a share of the surplus on underwriting and a share of profit from investments. The Wakalah model is more prevalent in the Middle East region. In this model, the Takaful operator acts as an agent for the participants and manages the takaful/retakaful fund in return for a defined fee.

Contributions are made into the risk pool. From this pool, direct, indirect expenses and claims are paid. If there is a surplus, this is shared amongst participants. Deficits are also made up with additional contributions from participants or with an interest-free loan from the operator. Money is invested into Shari'ah approved investment vehicles such as property, sukkuk bonds, or equities. Accounting practices in the takaful model are slightly different. Payout of the fund's excess to participants at the end of the contract is linked to when the donation was made. A donation that was three months late receives only three-quarters of the excess. Treatment of the operator's management expense is also key. This expense is treated separately from other costs such as payment of claims, retakaful, and reserves.

Operational challenges

Many of the challenges facing takaful operators are strategic as this formative market tries to establish itself. There is little infrastructure for the new business. While skills and resources can be borrowed from conventional insurance markets, there is significant investment required creating the business: establishing the Shari'ah board, developing technical expertise on Shari'ah compliance, training staff, creating brand awareness among customers, and implementing the appropriate technology. Alongside all this, the operator will need to work with the national regulator to bring them on board.

Most takaful operators are also in emerging markets, and as such, they face challenges such as immature banking infrastructure, poor communications infrastructure, and small pockets for IT investment.

However, there are some specific differences underlining how takafuls are underperforming their conventional counterparts. Takafuls show higher expenses, less capital, less employee productivity, and less income on assets. However, takafuls also show higher retention ratios and solvency margins.

A 2005 report by McKinsey & Co. titled "Islamic Banking Competitiveness Report" highlighted the two most important factors in choosing an Islamic bank: first, respect of Shari'ah principles; and second, quality of service. The respondents noted that most of the banks were especially good at the first factor; they needed to drastically improve on customer focus.

Challenges and the IT response

The takaful industry faces two key challenges that can be supported with by technology.

Customer service

Poor customer service results in high customer turnover rates. Understanding the characteristics of the customer requires a reflective process of consolidating and analysing vast amounts of data to improve service to the existing base. This knowledge is important in the development of appropriate customer sales and service channels as well as future product development. Key to takaful is transparency to customers in how their contributions are being managed. The operator must be in a position to respond in a timely and meaningful manner to such requests from participants.

Productivity and expenses are inter-related challenges

Productivity issues are often a result of the lack of standardised and automated processes. Low productivity results in higher expenses. Technology has a key role to play in supporting straight-through processing with tools such as business rules engines, workflow, document management, and policy management systems.

Conclusion

Takaful is a viable alternative to conventional insurance for the world's 1.6 billion Muslims, and this market is set to grow substantially in the coming years. Malaysia and the Middle East are where the much of the current and future business will be secured. More licenses are being awarded in these regions to both local operators and traditional insurers. The market faces many challenges, not least of which is the awareness that takaful is a Shari'ah-compliant form of insurance.

The global insurer considering entering this new market should consider the following:

Don't underestimate the required investment

Many of the challenges facing takaful operators are strategic as this formative market tries to establish itself. Although skills and resources can be borrowed from conventional insurance markets, there is significant investment required creating the business: establishing the Shari'ah board, developing technical expertise on Shari'ah compliance, training staff, and implementing the appropriate technology.

The emerging market of the resident country presents its own challenges

The larger markets for takaful are in emerging countries such as in the Asia-Pacific region or the Middle East. These countries pose their own challenges such as immature banking infrastructure, poor communications infrastructure, and small pools of IT resources.

The technology vendor should keep the following in mind:

It is critical to have a clear understanding on Shari'ah law as it pertains to takaful.

This extends from product definition through to claims and accounting of expenses and operator fees. Takaful operators will expect to see this level of expertise among the vendor staff(s).

There is a role for the vendor to support the business in addressing problems of customer service and productivity.

Tools such as business process rules engines, business process management, and policy administration systems could all play a key part. Modern tools with inherent flexibility are well placed to support what is ultimately an alternative way of managing the business.

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Celent is a research and consulting firm focused on the application of information technology in the global financial services industry. This extract was taken from the report *An overview Islamic insurance: Market Trends and Technology considerations*, November 2006. This report can be purchased in full and a 25% discount is offered to all ICMIF members.

If you would like more information on ICMIF and its services to the takaful sector, please contact Sabbir Patel (*sabbir@icmif.org*), or visit *www.takaful.coop*.