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Liquidity Risk
The Takaful Perspective

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Life Insurance / Family Takaful

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- In addition to mortality risk there is also a saving component
- Policyholders/participants are a party to a contract with the life insurer / takaful operator to pay a premium / contribution over a specified duration.

Family Takaful Contribution

Family Takaful Contribution split into

- – risk portion, Participants Special Account
- – savings portion, Participants Account

Why is this savings component different from deposit with banks

- The amount set aside for insurance / family takaful is designated for long term savings i.e. money not required for day to day expenses
- The amount set aside in the bank is primarily amount that can be called upon at short notice to meet daily expenses.

The public's expectation

- Family Takaful has been sold based on expected long term investment return. Typically the rate used for illustration is higher than bank savings rate.
- Bank's savings rate is short term, based on the bank's earnings and liquidity requirement.

What the public may not be aware of

- The savings element in Takaful may be subject to capital fluctuation i.e. you may get less than what you invest - the participant is subject to market risk.

  Compare this under a bank savings account where there is very little likelihood of the depositor losing his capital - the depositor is only subject to credit risk.

Islamic contracts … (1)

Takaful Contracts

- Mudharabah contract
- Wakala contract

Capital / market risk on investment is borne by the participant. Extremely important that the participant is made aware of this.

Islamic contracts … (2)

From the Takaful Operators perspective the primary objective for investment would be maximising the long term return, liquidity is not the primary objective where the savings component of Takaful is involved

- This freedom from day to day liquidity consideration allows the Takaful Operator to invest in equities and other long term investment vehicles
- This should result in higher return over the long term for the participant

The Risk Account … (1)

- Under this account there may be a need to pay claims at immediate notice
- The Takaful Operator can therefore be subject to liquidity risk

The Risk Account … (2)

In order to mitigate the liquidity risk:

- the Takaful Operator takes out an appropriate retakaful program
- the Takaful Operator invests the risk contribution in short term / easily realiseable / marketable assets. These investments usually do not carry much market risk (i.e. capital is not at risk).

Islamic Banks and Takaful
- underpinning Islamic Finance

- The Takaful industry support the "long-end" of the capital market, while Islamic bank the "short-end". A bigger Takaful Market will ensure a continuous supply of long term capital for the Islamic Financial system.

Thank you