

## Setup Issues In Starting Takaful



As an increasing number of takaful and retakaful companies are being formed around the world, it is an opportune time to discuss the very basic issue of setting up Islamic insurance entities. **Mr Hassan Scott Odierno**, Consultant/Actuary at Mercer Zainal Consulting, shares his views on the myriad range of decisions to be taken in creating a takaful company, as well as the considerations to take heed of in arriving at those decisions.

Once the decision is made to start takaful operations, a committee is formed consisting of the company management, the actuary /technical advisor, and the Shariah council.

The company management is normally concerned with the direction of the takaful operations. This would include making decisions such as the types of products to be launched as well as the model choice and its "saleability" to the public and the distribution force. The Shariah council has, as its responsibility, to ensure that all aspects of the takaful operations are in accordance with Islamic principles. The actuary is concerned with the viability of operations and the technical soundness of the model. The actuary will use traditional expertise in insurance topics as well as knowledge of Shariah issues to create takaful operations where there is true differentiation, bringing appropriate technical issues to the attention of the Shariah council.

The takaful setup committee working together will ensure that the "black box" nature of conventional insurance, where the policyholder is not aware of what happens to insurance premiums and profits, is not present in the takaful operations.

Takaful operations have transparency as a goal, where it is clear to the participant where his contributions go and how investment and underwriting profits are shared, as well as the charges taken by the operator. The committee will also determine the level of gharar (uncertainty) which will be acceptable in the takaful operations. Other technical issues will be discussed in the context of Shariah concerns, such as suicide clauses, double benefits for accidental death, death benefits to children under children's endowment policies, whole-life contract terms, and Islamic exclusion clauses.

### Level of Capitalisation

It is quite possible that the level of capitalisation will be set by regulations. However, if this is not set by regulations, then the actuary will need to weigh the concerns of shareholders with those of participants and the Shariah council.

It is normal to think that the more capital there is to start with the better, as this provides assurance to participants as well as rating agencies and regulators. However, shareholders expect a certain return on their capital. With a higher level of capital, the profitability of the products sold must also be higher. This may have an effect on the competitiveness of the products as well as possible Shariah concerns if the products are

perceived as "too profitable". This question comes down to one of understanding the risks of the operations and setting the level of capitalisation appropriately.

This is an issue worldwide in conventional insurance in the form of risk-based capital, and will also be an issue for takaful in the near future. In takaful, there are special considerations such as the model being used and the concept of takaful being more about managing risk rather than transfer of risk which is inherent in conventional insurance.

### Model Selection

The contract or model chosen will determine such issues as who pays for expenses incurred in the business venture, how profits are shared between parties in the agreement, and who is responsible for losses from the venture. Potential models would include:

- Mudharaba;
- Modified Mudharaba (sharing in underwriting surplus);
- Wakala;
- Wakala with mudharaba in investment profit;
- Wakala with incentive compensation (sharing in underwriting surplus).

The choice of which model to choose would depend on regulatory constraints as well as Shariah and actuarial



concerns. Regulatory constraints may place restrictions on the model to be adopted, such as the use of the mudharaba model in Sudan, and the wakala model and wakala with mudharaba in investment profit in Bahrain. In other countries such as Malaysia, both mudharaba and wakala models can be used.

The Shariah council may have concerns about certain models, in particular the modified mudharaba and wakala with incentive compensation, where the underwriting surplus is shared. Again, this would depend on the region and even the Shariah council within a region.

The actuary would determine which models and parameters have optimal characteristics, involving such matters as the matching of income with expenditure and asset liability management concerns. Other issues such as adjusting the level of risk taking with respect to investment, mortality / benefit risks, and expense risks can be dealt with via model and parameter choice.

#### Initial Product Development

A key issue in the initial setup of takaful operations is the products to be sold. In some cases, a grand launch is planned with a full line-up of products and a full organisational structure.

In other cases, a lean operation is set up, with the initial products sold focusing on "low hanging fruits", ie business which can easily be achieved.

Issues such as agency force versus bancatakaful would also be discussed, as will the level of complexity of prod-

ucts sold.

Ordinarily more complicated products such as annuities would be held off until later in the companies' operations.

Initial product development will also focus on the level of competitiveness of takaful products versus conventional products sold, as there is significant risk of anti-selection by participants where both conventional and takaful products are sold.

Other issues would include whether to unitise the products or to use pooled funds, as well as the number of risk funds to maintain, which affects the level of surplus sharing for individual participants.

Finally, information technology issues will also need to be taken into account of when developing the initial products, with restructuring of the model and products possibly being required and/or purchasing of more extensive IT systems.

#### Takaful is More than a Name Change

Takaful is a different approach to insurance, mixing technical competence with Islamic principles and the profitability needs of shareholders. These needs can be met with the help of actuaries who understand both the technical as well as Shariah aspects of takaful. ■

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