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The Importance of effective pricing in General Takaful

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How does Takaful differ from conventional insurance?

Risk

- Concept of mutual assistance among participants exists in Takaful. In conventional insurance the shareholders underwrites ***Risks*** in return for taking 100% of the profits.
- Under conventional insurance once the premium is paid, that premium 'belongs' to the shareholders of the insurance company in return for a promise from the insurance company to pay should a claim arise.

What are these Risks that Conventional insurers undertake?

- That claims exceeds premiums collected.
- That management and other expenses incurred in running the business are too high.
- That it loses money on the investment of its assets (typically equity investments and fixed income securities).

Investments

- Insurance involves the acceptance of premium before providing for cover. Thus even if premiums are equal to claims, this feature together with the delay associated before claims can be settled means there is an accumulation of assets. These assets can be in non shariah compliant investments with elements of riba (interest) and forbidden activities (e.g. gambling and brewery stocks).
- There is a Risk that should these assets fail/default the insurer may not have sufficient resources to pay claims.

Takaful is an alternative to managing these *Risks* through the utilisation of the various Islamic contracts approved by Shariah.

Islamic contracts are contract 'types'. A particular type of contract confers on the parties to the contract specific rights.

Basic Requirements

All Shariah approved contract avoids:

- Riba (Usury)
- Maysir (Gambling)
- Gharar (Uncertainty)

Firstly, Takaful is not about gambling…

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If you lose you Proton Saga you don't get to replace it with a BMW...

Firstly, Takaful is not about gambling...

If you lose you Proton Saga you don't get to replace it with a BMW...

Nor do you get to replace it with a new Proton Saga.....

Its about mutual assistance, helping your fellow participants in their hour of need...

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You could be next to lose your car!

Under Takaful the premium (called contributions) are donated to a Risk pool and thereafter belongs to that pool. It does not belong to the Takaful Operator nor in fact does it belong anymore to the individual participants.

Because under Takaful, contributions have to be paid first before you are accepted as a participant, there is a need to determine the appropriate price (the Contribution premium) for that privilege to be accepted into the Risk pool.....

Islamic Contracts under Takaful

- There are two types of Islamic contract used under Takaful in Malaysia
  - Wakala contract
  - Mudharabah contract
- Both contracts however are supplemented by the Islamic Contract of Tabarru' (donation) to address the issue of Gharar which is unavoidable when there are uncertainty in the matter of claims (both the incidence of claims and the amount of claims).

Contribution determination under the Wakala contract

- Wakala is an Agency contract. For a fee the *Wakil* performs a service.
- In Takaful this service involves:
  - Determining the Contribution rate which is fair to participant
  - Determining how assets are invested
  - Ensuring claims are paid judiciously
- In return for this service the Takaful Operator (being the *Wakil*) receives a Wakala fee.

How is this fee determined?

- How much expenses the *Wakil* expects to incur to provide each of the services listed.
- Ideally, the fee should be related to the service performed and perhaps also how well the service is performed.

Examples of fee type

- Fixed ringgit amount per participant
- As a percentage of the Contribution received
- As a percentage of the assets under management

All fees are subject to review of the Shariah Board and must be disclosed to the participant at the outset of the Takaful cover. This disclosure is important so as to avoid Gharar.

- How much surplus does it need to service its capital.

To this fee we then add the expected
cost of settling expected claims…

How is the cost of claims determined?

- need to determine the number of claims expected over the period of Takaful cover (i.e. the claims frequency).
- need to determine the average claim cost for each claim* (need to determine the claim amount distribution).
- need to determine the cost of *Retakaful* (Reinsurance).

Expected Cost of Claims = Claims Frequency x Average Claim Cost* + Cost of Retakaful

**net of Retakaful recoveries*

Determination of claims frequency and average claims cost requires investigation of past statistics on claims frequency and claims amount for participants with common risk factors.

What are risk factors?

For motor insurance this could be:

(i) Engine capacity

(ii) Age of car

(iii) Type of car

(iv) Cost of car

(v) Age of driver

(vi) Number of years since the last accident/claim

Typically there is a base contribution to which loadings are added depending on the risk type. For example there could be a 10% loading if the driver is below age 25 say.

Contribution rate under the Wakala contract is then determined as

Wakala fee + expected cost of claims + margin^{w}

Why bother with pricing 'correctly'? Why not charge every Participant the same rate regardless of his Risk profile? Is that not more in line with the concept of mutual help?

Need for pricing correctly can be summarised as follows:

- Concept of equity. Those who are bad risks (i.e. more likely to result in a claim) should be made to make a higher contribution to the Takaful pool.
- There is choice of Takaful Operators to the consumer. The good risk (i.e. those unlikely to make a claim) would go to the Operator charging the lowest contribution for his particular risk profile.
- Need for Takaful Operator to cover his expenses and provide a reasonable return on Capital to its shareholders.

What about contribution determination under the Mudharabah contract?

- Mudharabah contract is a contract of profit sharing.
- In Takaful other than profit from investing the contributions before having to pay claims there is no profit per say unless there are no claims!
- However, surplus does arise when contributions collected exceeds claims. Under Mudharabah this surplus is treated as profits and is distributed on a pre agreed percentage with the participants.

Contribution under the Mudharabah contract is determined as follows:

Expected cost of claims + margin^{m}

- Margin^{m} is the **planned** surplus at the end of the year after paying all claims.
- Where margin^{m} is greater than margin^{w}.

The Operator’s share of Margin^{m} must be determined such that it is sufficient to pay for the Operators expenses and a reasonable return on the shareholders capital

Which is better, a Wakala based contract or a Mudharabah based contract?

Consumer's perspective

- As under the Mudharabah contract the Operator can only recover its expenses after all claims are paid there is added impetus for the Operator to run a 'profitable' Takaful pool.
- Contribution rates are not necessarily 'cheaper' than that for the Operator operating on a Wakala basis even though no upfront fees are charged.
- Participants are more likely to get a profit refund at the end of the contract period under a Mudharabah contract.

Operator’s perspective

Under the Wakala contract the operator has more control over its financials. It can expect an income notwithstanding claims cost are less or more than the contributions collected.

The distorting effect of Tariffs

- Where the regulation and/or market practice is such the contribution rates are fixed on an industry basis and thus may not relate to the company's current experience, surplus or deficit arising in a year would be very large or very small or a loss may occur.
- As a result of this more than likely there will be cross subsidy between different classes of risks e.g. motor can be unprofitable, fire class on the other hand very profitable and the latter is used to support the former.
- This imbalance cannot be sustained over the long term.

The distorting effect of capital requirement

- Should the capital requirement for Takaful be set too high, the cost of Takaful cover would be set unnecessarily too high. This would make Takaful uncompetitive as compared to conventional insurance.
- Takaful involves the sharing of surplus between participants and shareholders. Thus, in order to support the same amount of capital as conventional insurance, takaful contribution rates must be set higher than conventional insurance for the same risk.
- What is the right amount of capital for Takaful?

It should not be the same as for Conventional Insurance…..

Why Rate in Takaful?

- Rating differs according to the Takaful model adopted.
- Rating ensures participants pay a fair contribution
- Rating allows for a fair basis for surplus distribution
- Rating allows the Takaful Operator to compete effectively in the market
- Rating appropriately allows the Takaful Operator to receive a fair return on capital employed….