Developing takaful retirement products

Ms Farzana Ismail of **Actuarial Partners Consulting** studies the takaful retirement market, and suggests ways to overcome the challenges in developing suitable products.

With greater awareness of health-related issues, medical advancement and increasing access to a better quality of life, most countries globally are observing increasing life expectancies amongst its population in recent years.

One of the long-term repercussions of greater life expectancies is the need for retirement products that will provide financial aid and planning at the older ages. Muslim consumers are also getting to be more financially savvy, creating a demand for retirement products that are Shariah-compliant. This demand will be further fuelled by changing demographics such as families having fewer children and globalisation, thus reducing the ability to rely on others for old age assistance.

Annuities are the most common pension product to manage longevity risk. In a traditional conventional annuity policy, annuities provide a regular stream of fixed and guaranteed income to pensioners until death.

The existing takaful retirement market

There have been several attempts to fill the gap in the takaful retirement market. For example, Allianz Takaful, based in the Middle East, has been attempting to launch its first Islamic annuity product since 2009 to tap into the growing number of Middle East consumers who are keen to increase their state pension. Allianz Takaful has already been selling a pension product which pays out over a pre-agreed number of years, but not annuities with benefits payout until death.

In Malaysia, a national scheme made up of takaful and conventional annuity products was launched in 2000, but was soon withdrawn from the market due to negative press about conventional annuity products. HSBC Amanah Takaful in Malaysia also recently launched a takaful retirement plan which provides non-guaranteed annuities up to age 75 and a non-guaranteed maturity payout. In the UK, Shariah-compliant private pension funds are heavily backed by equities and properties to avoid interest-bearing investments.

In spite of these efforts, takaful retirement products are largely non-existent due to certain limitations.

Challenges in developing takaful annuities

Sukuk availability

In the conventional world, annuities are typically backed by bonds to produce a stream of regular income to match the annuity payout to the policyholders. Since annuities are typically paid out until death, long-term bonds are selected for investment to match the duration of the liability. The matching of income and outgo streams, and of duration between assets and pensions liabilities are necessary to minimise capital volatility and capital requirement from an insurer's perspective.

In terms of Islamic assets, sukuk are the nearest equivalent to bonds. However, there is a shortage of sukuk for takaful companies as most sukuk are typically bought by large banks. The secondary sukuk market is also largely illiquid and expensive.

In addition, there is an issue on the availability of long-term sukuk (for example, with terms of 20 to 30 years) as most sukuk in the market are of short to medium term in duration. Without appropriate assets, providing for annuity products can be capital intensive. Thus, the lack of availability of suitable assets to back annuities remains to be one of the key stumbling blocks in developing takaful annuities.

Product structure of annuities

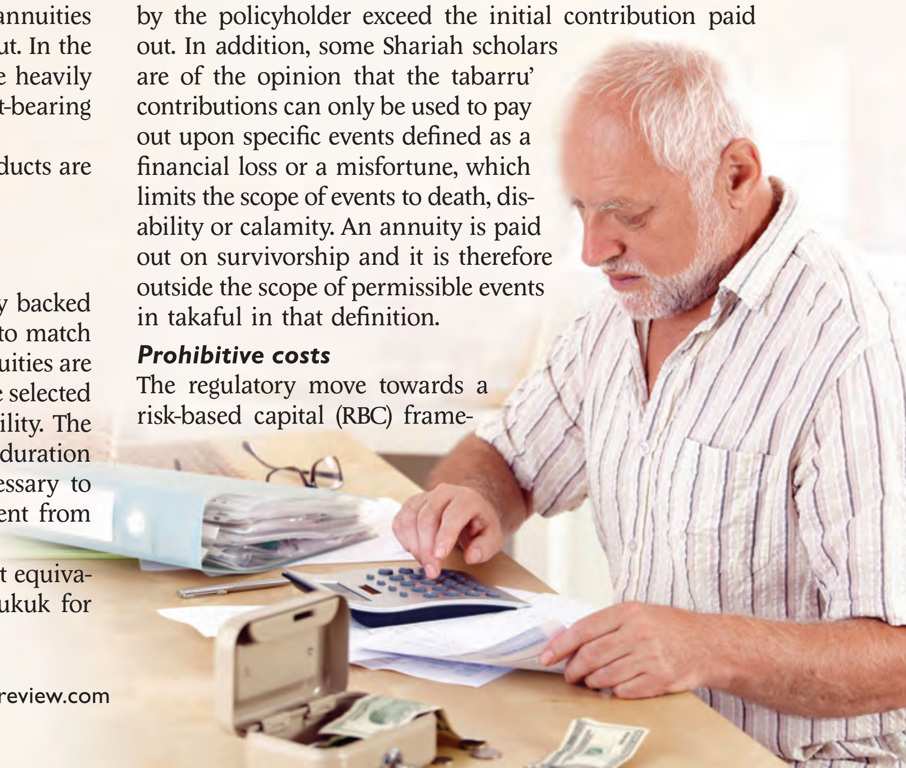
There are also several key Shariah issues on the existing product structure of annuities. Firstly, there is the issue of the guaranteed feature in annuities as conventional annuity payouts are typically fixed and guaranteed for the duration of the participant's life. There are also solvency issues if the takaful fund is in deficit. If a Qard (loan) is required to remove the deficit, correspondingly, there is a question on who should repay the Qard. If the takaful operator is fully responsible to provide for Qard, then there is an effective transfer of risk to the operator as the operator is essentially providing for the guarantee. Such risk transfer is not permitted in takaful. However, the surviving pensioners are not likely to be able to increase their contribution amount to eliminate the Qard as they are no longer in employment. Imposing the increased contributions on the younger, deferred annuitants will result in a cross subsidy between generations and is not likely to be fair and equitable.

Issues of permissibility

In addition, there is an issue on pooling of longevity risk in the takaful fund as participants will be donating as well as withdrawing regular income from the pool. There is also a potential issue of riba if the annuity payments received by the policyholder exceed the initial contribution paid out. In addition, some Shariah scholars are of the opinion that the tabarru' contributions can only be used to pay out upon specific events defined as a financial loss or a misfortune, which limits the scope of events to death, disability or calamity. An annuity is paid out on survivorship and it is therefore outside the scope of permissible events in takaful in that definition.

Prohibitive costs

The regulatory move towards a risk-based capital (RBC) frame-



work has also made annuities more expensive. There are uncertainties on how long the existing mortality improvements will continue in the future, which makes annuities difficult to price and reserve for appropriately. Under the RBC framework, increasing uncertainty combined with the guarantees provided in conventional annuities result in penal capital requirements, thus making annuities more expensive.

For example, in Singapore, annuities are no longer offered in the market due to its high capital requirements in the local RBC framework. Similar challenges are also observed in Malaysia.

Overcoming some of the challenges

Several steps have been taken in certain countries to overcome some of these challenges. In Malaysia, the Shariah Advisory Council (SAC) of Bank Negara Malaysia resolved that the benefits payment from the Participants' Risk Fund (which pools the tabarru' contributions) can be paid out in events not limited to death, disability or calamity, subject to agreement by all participants. This is in line with the feature of the takaful contract which is based on the concept of tabarru' and ta'awuni. This resolution is seen as paving the way in developing takaful annuity products in the Malaysian market.

An example of a potential takaful annuity product structure is shown in Figure 1. This structure applies a waqf concept which was used in the takaful annuity plans sold briefly in Malaysia.

Takaful annuity payments can be structured to be non-guaranteed on retirement, with the participants sharing all risks (including longevity and investment risks). This addresses the solvency issue on providing for guarantees and qard as the annuity amount can be adjusted at regular intervals for any significant changes in longevity risk, taking into account the amount of assets left in the fund to be shared amongst the surviving annuitants. To maintain equity, the determination of the annuity amount should also be segregated by cohorts of participants to limit intergenerational cross-subsidy. To make this type of structure a success, takaful operators will need to market the unique nature of takaful, its potential upside and inflation protection rather than compete directly with conventional products.

In addition, as the takaful operator is only managing the risk instead of taking on the risk, the capital requirements for takaful annuities should also be lower compared to a conventional annuity product with guarantees. This means that takaful annuities can be more affordable compared to conventional annuities. Regulators need to recognise the real and practical differences between takaful and conventional products in setting regulations and capital requirements.

Due to the lack of long-term sukuk, annuities can also be backed by real assets such as equities and properties, which can also be used to manage inflation risk. However, there is an issue with liquidity risk and the income stream is likely to be more volatile for these asset classes.

Another Islamic asset class is an investment in Islamic bank accounts, but the returns are significantly lower and are not likely to provide sufficient income to support the expected outgo and capital requirements of an annuity product.

However, in the product example above, there remain Shariah concerns on the waqf concept as the waqf assets cannot depreciate in value. In annuities, the assets are drawn down which will diminish the value of assets over time. Innovative product designs are essential to overcome these Shariah issues to provide for retirement benefits.

Collaborative effort needed to join the pieces

Scholars around the world need to work together to come to an agreeable solution to enable the development of takaful retirement products. In addition to a unified view on a Shariah-compliant retirement product structure, the Islamic finance industry needs to work together to address the issue on the availability of long-term sukuk to back these retirement products. As takaful annuities can be structured with no guarantees, takaful operators can capitalise on the potentially lower capital requirements under the RBC framework.

The combined efforts of scholars, takaful practitioners and regulators will create an opportunity for takaful operators to tap into the retirement market with an affordable annuity product to meet the increasing demand for takaful pensions products. M

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Figure 1: Example of a takaful annuity product structure