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Tackling issues

Although the Takaful industry has seen double digit growth since 2010 according to reports, it still suffers from a lack of penetration in supposedly vibrant markets, and is still performing at what is considered to be lackluster levels. Saudi Arabia remains by far the largest Takaful market, contributing US$4.3 billion or 51.8% of the industry at an average contribution per operator of US$141 million. Malaysia, considered one of the largest markets in the Islamic capital market space, grew 24% to reach contributions of US$1.4 billion at an average contribution per operator of US$141 million. The UAE, with contributions of US$818 million, has charted a growth rate of 28%; whilst Sudan, which is considered to be the most significant market outside of the GCC and Southeast Asia, has seen more than 7% growth since 2010, with contributions totalling US$363 million.

Many within the industry have admitted to a gamut of issues which need to be addressed urgently and effectively in order to allow the industry to perform at its best; particularly in the investment space, where Takaful companies are suffering from a dearth of long-term investment opportunities to suit their risk and investment profiles. Another issue stems from the lack of risk-based capital, where there is a mismatch between the companies' assets and liabilities, and the universal issue of lack of talent and understanding of Shariah based insurance products.

And although the global credit crisis has contributed to the slow-down in the growth of the Takaful industry, with lower returns all round for shareholders and Takaful policyholders and slower business growth on the back of a contracting economy, there is still much untapped potential in the re-Takaful sector, which has on the contrary seen new players entering the market due to the lower entry cost for re-Takaful operators, and the ability to write business on a global scale.

In this issue of Islamic Finance *news* Supplements, we take a closer look at the fundamentals of the Takaful industry, its issues from a macro and micro perspective, and what needs to be done to mitigate these problems in order to prevent a stagnation of growth within a sector which is ultimately brimming with potential.

Nazneen Halim,
Editor

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The Takaful and re-Takaful industry: An overview

Considering the success of the conventional insurance and re-insurance industry, and the sheer size of the Muslim population, the Takaful and re-Takaful industry has registered disappointing growth over the last few years despite a growing number of players on the scene. NAZNEEN HALIM takes a closer look at this mismatch and addresses the pressing issues plaguing the sector.

Across the board, Takaful and re-Takaful players are discussing strategies and re-thinking opportunities on all fronts, from product development and innovation, new markets and marketing strategies to investment opportunities. Standards and regulations have also become an integral part of the growth of the Takaful and re-Takaful industry, with financial reporting and risk management key areas in dire need of attention. According to Ajmal Bhatty, the president and CEO of Tokio Marine Middle East in the UAE, the Takaful industry is still evolving, and needs to innovate particularly in the areas of asset management, Sukuk and risk hedging. "These are important areas for Takaful where good asset liability matching is paramount with secure and competitive returns," he said.

The global credit crisis has not helped with the sector's growth either, with market players citing it as an indirect cause of its stymied growth. Tobias Frenz, CEO of MunichRe Retakaful, elucidated: "The crisis has in one way or the other negatively affected all financial institutions, both Takaful and conventional. The direct consequences were felt on both the bottom- and top-line, with lower returns for both shareholders and Takaful participants/ insurance policyholders and slower new business growth on the back of a slowing or contracting economy. For Takaful in particular we have observed a notable slowdown in the set-up of new operators in recent years; which is a direct cause of the capital crunch." He added: "The re-Takaful market on the other hand has not seen a slow-down as far as new operators are concerned. New players continue entering the market because the entry-costs for re-Takaful operators are significantly lower and they can write business globally unlike their counterparts on the direct side. However, what we experience is a high degree of overcapacity on Family and General Takaful retail lines as too many re-Takaful operators are competing for a smaller than expected Takaful business."

Regulatory concerns

The crisis has also highlighted the need for regulatory bodies to strengthen their supervisory roles to ensure that stakeholders in the Takaful industry chain are protected and buffered from another crisis should it occur. Standard setting bodies such as the IFSB and AAOIFI have already brought to light issues with regards to solvency for Takaful operations, governance and risk management, but need to tackle these challenges head-on and as quickly as possible in order to allow for sound and stable development of the Takaful industry. The differing standards across jurisdictions for the Takaful industry has also served as a double-edged sword for Takaful operators; allowing flexibility on home ground, but hindering cross-border development and movement of products and investments. An industry player revealed: "While most operators agree that the new regulations are a positive development, they are concerned over increased variances in regulatory regimes across jurisdictions. Such variances make it difficult for Takaful operators to function across regions and also lead to confusion for customers and multinational insurers."

Ajmal, who are based in the UAE, revealed that the country's regulators have been improving its regulatory environment, and pro-active in their support for the creation of new Takaful companies. However, he added that industry-wide clarity is needed in several areas such as risk sharing vis-à-vis risk transfer, particularly at the re-Takaful level, gaps between theory and practice of Takaful structures and definitions that affects

the use and application of Takaful business models, and the need for risk-based capital. "In Malaysia, the regulators have already outlined their requirements for the Takaful industry, including critical areas such as solvency, and I foresee other markets introducing relevant measures in due course. The IFSB standard on solvency for Takaful companies (IFSB11) highlights the importance of having more capital when the liabilities outweigh the assets."

He added: "If you are writing more business, which involves varying degrees of risk, there is a need for more capital to enable operators to write the risks, and it is for the shareholders to consider providing additional capital, but at what cost?

After all, Takaful as it is being practiced in the market, is a commercial activity (Takaful Tejari) and the shareholders would look for returns commensurate with their business risks. The concept of Tabarru contribution is more of a charitable act—a gift or donation, and the payment of claims is also a "gift" back from the Takaful cooperative pool to the participant. This calls for alignment of the commercial nature of the business of Takaful with its benevolent concepts. There are a lot of issues that are inter-related and need to be addressed."

Takaful and re-Takaful products have traditionally been in direct competition with the conventional insurance market; with the Shariah compliant sector looking to convert conventional insurance subscribers to their market. Recognizing this, there has been a call across the board for more innovation, and a pressing need for education for Shariah compliant insurance products to attract the volumes of Muslims and non-Muslims alike who are currently subscribed to conventional insurance. "Takaful companies need to re-think how they explain Takaful concepts and how they approach market segments. They can actually attract new customers if they can come up with new, innovative ways to explain what Takaful is about, and to increase the size and penetration of these untapped markets which can only be unlocked by Takaful companies," Ajmal explained.

Regressing?

In a recently published report, it was stated that the Takaful industry has seen a deceleration in growth in previously core markets such as Bahrain, and to some extent Malaysia. It said: "Growth in Bahrain and Malaysia, regarded as the most well-developed Takaful markets, is also showing signs of flagging, though it still outpaces conventional insurance." Recent data from the central bank of Bahrain shows Takaful premiums grew 20% in 2010, sorely lagging behind the 70% increase in 2008. Total assets expanded by 12% in 2010 against 52% in 2007.

Bahrain, one of the frontier markets for the Takaful and re-Takaful industry, was one of the first countries to create regulations specific to this sector. However, the global credit crisis hit the kingdom hard, causing assets to decrease by 35% in 2008, and prompted a review of Takaful and re-Takaful operations across the board. The report added: "The deceleration could be hard to reverse because of a shrinking sales force in the industry. The number of employees involved in General Takaful sales in Malaysia peaked at 32,997 in 2009, when it soared by 107% from the previous year; but contracted by 5% in 2010. On the other hand, staffing for the conventional insurance industry fell by just 2%. If these patterns continue, the global Takaful industry could slow to single-digit growth in coming years. But some operators are determined to tap new markets to prevent this."

Other challenges plaguing the industry include a lack of long-term Shariah compliant investments for Takaful companies, lack of resources and human capital, as well as the issues of risk sharing and risk transfer, including risk-based capital and returns to shareholders - all of which are fundamental issues that could potentially stymie the growth of the industry if not addressed promptly.

Frenz revealed: "The lack of suitable Shariah compliant investments is probably the biggest challenge operators are facing currently, besides the competitive pressure. It is difficult for the industry to rectify this without the full backing of the regulator. But even then, it is a mammoth task. Malaysia is a case in point where Bank Negara Malaysia is proactive in closing the duration gap and investment options. But it is still far from sufficient to fulfil the operators' needs. This is reflected in lower returns for Takaful operators compared to their conventional peers."

He added: "Operators can naturally soften the impact by limiting the exposure to implicit long-term guarantees. Implicit, as by definition there should be no explicit investment guarantee under Takaful. But the mandatory Qardh requirement in most regulations and a lack of transparent and true risk-sharing principles in the Takaful contract wordings are ultimately nothing but indirect guarantees the operator has to fulfil."

Rising competition, a lack of suitable Shariah compliant investments, shortage of expertise and evolving regulations are common challenges to operators in Southeast Asia and the GCC. Moreover, operators in the GCC struggle to control cost and achieve sustainable underwriting profits, calling for the need to consolidate in the mid-to long-term. The lack of re-Takaful capacity has also been identified as a major hindrance to the industry's growth, but has improved between 2009 to 2011, indicating that the influx of new re-Takaful operators in the last five years have been providing sufficient capacity to support the direct writers, particularly in the personal and retail lines of business.

Moving forward

Should the industry tackle these fundamental issues head-on and capitalize on the massive potential across various jurisdictions from Southeast Asia to the GCC, Africa and Europe, industry players believe that the Takaful and re-Takaful industry will maintain a positive outlook. Consolidation is also an integral part of the industry's growth, and there needs to be rationalization in the market as to how these companies will move forward.

It is encouraging to see how far the industry has come, and to witness regulators and standard setting bodies such as AAOIFI and the IFSB actively pursuing discussions on how to create a seamless Takaful and re-Takaful industry. However, as everything is inextricably linked within this nascent Islamic finance industry, financial institutions and banks ultimately play a huge role in creating suitable Shariah compliant investments for Takaful operators to allow the industry to progress.

On the horizon

NAZNEEN HALIM examines the growth potential of emerging markets within the Takaful industry.

According to the recent Ernst & Young Takaful Report 2012, the Takaful market share in the GCC and Malaysia currently stands at 15% and 10% respectively; much less than the industry's potential as a whole in these markets. In terms of consumer segmentation, the Shariah appeal of Takaful makes it predominantly retail-driven in most markets. The corporate business is attracted through a value proposition based on the operators' reputation, history, product suite, service standards, relationships and pricing, and this segment has significant room for growth.

Gordon Bennie, the MENA financial services industry leader at Ernst & Young, said: "The GCC Takaful market predominantly comprises of General Takaful business with Family Takaful accounting for as little as 5% in certain markets. With high disposable income average and low market penetration, the GCC presents great potential for Family Takaful. Focus on customer research to understand needs and expectations, in addition to focus on customer education and distribution capacity-building, would allow this market to be tapped. Large Muslim markets such as Libya, Egypt, Bangladesh, Indonesia and Brunei are opening up to Takaful."

Tobias Frenz, CEO at Munich Re in Malaysia, also revealed: "Malaysia is the biggest and most developed Takaful market worldwide. It has the necessary regulatory and operational infrastructure and a committed regulator that is actively supporting the entire value chain of Islamic finance. Malaysia will thus remain the growth driver for Takaful for many more years to come, in particular on the Family Takaful side.

Outside of Malaysia, growth prospects of significant size are rare to find. We will see more Takaful growth for Pakistan following the amendment of the Takaful Rules 2005 that now allows the establishment of Takaful windows. Saudi Arabia is the market with the highest potential in the GCC as it has the scale and right fundamentals to challenge Malaysia in the mid- to long-term. We will see small pockets of new growth in Sri Lanka, Bangladesh and Egypt, but have to be mindful – again - that in absolute numbers it will remain small."

The Ernst & Young report also stated that insurance companies continued to yield higher returns with an average return on equity of 8% in the GCC compared to the Takaful operators with 4%. Operators in Saudi Arabia have struggled to show positive returns since the financial crisis. An industry player said: "The local market is currently dominated by three players, with the remaining operators incurring high expense ratios and loss ratios in their efforts to gain market share. Though the combined operating ratios of Malaysian Takaful operators are better than their conventional peers, the reverse is true for the GCC."

Strong competition, evolving regulations and shortage of Takaful expertise are identified as key risks in both the GCC and Southeast Asia. Young Takaful operators are relying upon aggressive pricing strategies to compete against the established, older, conventional players. Such pricing is not sustainable and causing significant pressure on the industry's profitability.

There are increasingly stringent regulatory requirements on capital and solvency, indicating the regulators' desired future direction. There is also a need for Takaful players to be more innovative and to break free from traditional products, which ultimately have mimicked their conventional counterparts. Ajmal Bhatty, CEO at Tokio Marine MENA, said: "It is alright for now because they are competing with the market, and that would probably be the first point of entry, but they need to be more innovative than that."

The African Takaful market, which is touted to be the "next big thing", also suffers from regulatory issues. Bureaucracy remains the greatest challenge on the African scene, with networking playing an important role in opening doors that could otherwise remain reluctant to such proposals. An industry player revealed: "It will take the governments to appreciate what is being achieved in Gambia and either replicating or consulting with more experienced nations to advise on the feasibility of gaining operational licenses to operate subsidiaries in their markets."

Other challenges that have emerged are in competition with the conventional market and are creating a price war - which is ultimately not sustainable. "Eventually the governments are going to have to step in and regulate as this trend is not beneficial for the industry to allow unhealthy competition through pricing," he revealed.

While most operators agree that the new regulations are a positive development, they are concerned over increased variances in regulatory regimes across jurisdictions. Such variances make it difficult for Takaful operators to function across regions and also lead to confusion for customers and multinational insurers. Ultimately, industry consolidation would allow Takaful operators to compete effectively with larger, more established conventional insurers and also reduce unhealthy price wars.

However, the industry is still growing rapidly which is keeping shareholders interested in their Takaful operations. Ashar Nazim, the MENA head of Islamic financial services at Ernst & Young, said: "The industry will take a bit more time to establish itself before it can be decided which players can sustain themselves and which cannot."

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The global Takaful outlook

The double digit growth rates of Takaful continued at a lower rate this year. The total contributions for 2010 fell short of the US$9.1 billion forecast by the World Takaful Report 2011 and totaled only US$8.3 billion, growing at 19% , a slower rate than in previous years.

The 2010 Ernst & Young Takaful report also predicts that the industry remains on its course to reach US$12 billion by end of this year.

"With current growth trends, and the addition of new fringe markets such as Indonesia and Bangladesh, we expect gross contributions of US$12 billion by 2012," said Ashar Nazim, the head of Islamic financial services at Ernst & Young MENA.

The total number of operators was estimated at 195. The GCC still holds the largest number at 77, but registered relatively low average contributions of US$63.5 million per operator while Malaysia leads the world with US$115.8 million with 14 operators. "There is a tremendous amount of catching up with Malaysia that we could see happen in the future," said Nazim.

A slowdown in traditional markets

The key markets of Takaful maintained their position as the largest in terms of contributions; however, they have witnessed a slower growth pace. Saudi Arabia, which provides about half of the total contributions, slowed to 12% in 2010, from a compound annual growth rate (CAGR) of 38% during 2005-2009.

Malaysia has proved more resilient but has followed a similar trend, according to data from the same report. Takaful assets grew 24% in 2010 against a 29% CAGR between 2005-2009.

Industry experts argue that if these growth patterns continue, the global Takaful industry could slow to single-digit growth in the near future.

New emerging markets

Despite the deceleration in growth in the dominant markets, Takaful potential remains significant, especially within the large Muslim population centers across the Middle East, Africa and Asia.

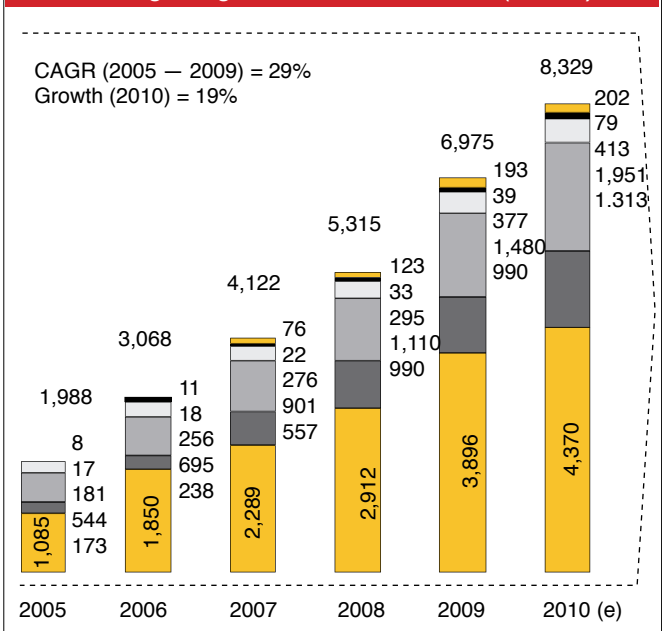
India, China, Russia, Turkey and CIS countries also all show huge potential for Takaful, based on the size of their Muslim populations and the growth in their economies.

Indonesia: Leading Southeast Asia to overtake the GCC

Indonesia is emerging as a prominent Takaful market, achieving higher growth rates and larger contributions than several GCC countries. Brunei has also grown at a phenomenal rate of 393% in 2010.

The region accounts today for US$2 billion in total contributions,

Table 1: The global gross Takaful contributions (USDMn)



Source: EY World Takaful Report 2012

and as the Ernst & Young report suggests: "With Saudi regulators disallowing the pure Takaful model, the primary hub for Takaful may well shift from the GCC to Southeast Asia." A report by Milliman also forecasts strong growth momentum for Takaful in Southeast Asia, suggesting it could become three times as large as the Middle East by 2015.

Africa

Africa has also witnessed considerable developments last year, with Kenya launching its first Takaful operator in January, and the acquisition in September of Takafol South Africa by Absa group, a leading financial institution majority owned by Barclays. Industry experts are predicting that this deal could have implications for the reach of Islamic insurance beyond the borders of South Africa to southern, central, West and East Africa.

In the north of the continent, where Takaful was born, Egypt and other Muslim majority North African countries such as Libya, Tunisia and Morocco are showing great potential for the near future.

Egypt already counts eight Takaful operators amongst its insurance providers, and analysts are optimistic that the

current ongoing reforms are more likely to give a boost to Islamic finance expansion in the country. In Algeria, the future of Takaful is bright as illustrated by Salama, the established UAE Islamic insurer who is enjoying a strong position in the North African country.

Europe

In Europe the maturity of the insurance industry and the presence of mutual insurance are encouraging the introduction and the extension of Takaful across the continent. Indeed, Mutual and Shariah compliant insurance providers have very much in common.

> **"Family Takaful is emerging as a growing force in the Shariah compliant segment, increasing life insurance penetration rates both in nascent and mature Takaful markets"**

In France for example, mutuals like Groupama, MMA and Macif have an important market share of the insurance business. Shariah compliant insurance is also in close alignment with the increasingly popular ethical and socially responsible investing that is witnessing a boom across Europe.

The UK, Germany and France are perceived as the largest markets for Takaful, and although only the UK currently has an operating Takaful operator along with Luxembourg, the new single passport system has the potential to significantly aid the growth and distribution of Takaful across the continent. Community banks like Chaabi bank (a subsidiary of Groupe Banque Populaire from Morocco), will play a major role in promoting Shariah compliant financial products.

The bank has already introduced the first Shariah compliant deposit account and plans to roll out a full set of Islamic financial products by the end of this year. In France the first Shariah compliant life insurance product will be introduced in the coming months with a target of EUR30 million (US$39.7 million) by 2013.

Family Takaful: A promising line of business

While Takaful is witnessing general growth among all its segments, particularly in health insurance which has benefited from compulsory policies in Saudi Arabia and UAE, Family Takaful is emerging as a growing force in the Shariah compliant segment, increasing life insurance penetration rates both in nascent and mature Takaful markets, as per the first edition of the Milliman Global Family Takaful Report 2011.

The same report estimated Family Takaful contributions at US$1.7 billion in 2010, accounting for 20% of total global Takaful gross written premiums. Malaysia is the largest and most mature Family Takaful market, holding 73% of total contributions, followed by the Middle East and Africa at 25%.

Family Takaful is projected to reach US$4.3 billion in the next three years: a 250% increase from 2010. "The growth in Family Takaful thus far outweighs both General Takaful growth as well as global conventional life insurance growth," notes the Milliman report. The segment remains underpenetrated as it is estimated to currently contribute only 5% in the MENA region compared to 77% in Malaysia.

Family Takaful market opportunities, especially in the investment-linked class, are substantial, given the low penetration, rising income, growing population and knowledge in this sector. In Malaysia, new business contributions from investment-linked products increased to US$125.3 million in 2010 from US$113 million in 2009, according to Bank Negara Malaysia. Investment-linked products accounted for 15.6% of the total new Takaful business contributions.

The ability of Takaful operators to increase insurance penetration is critical to their success. Family Takaful currently presents the greatest opportunity to achieve this because it provides the Muslim population with alternative protection and investment opportunities, and the Takaful insurers with increased profitability.

Value-driven customers

To strengthen their competitive position, Takaful operators are putting more emphasis on broadening their product range to capture the growing demand for more customized, niche and sophisticated products, from investment-linked and wealth management products among the more affluent customer base, to extending coverage to low-income individuals via micro-Takaful solutions.

The emergence of new customer segments with higher levels of awareness requires innovative approaches in targeting them, by addressing their specific needs and preferences as well as building better customer relationships, through effective communication tools, such as customer profiling, continuous updates and timely reporting.

More tailor-made products are further being introduced: such as ladies plans and affluent plans with individualized protection including critical illness cover, travel cover, and child protection.

Operational efficiency: A key driver

Many industry leaders are embracing innovative tools to deepen existing relationships and improve new customer acquisition rates, admitting that efficiency strength could be achieved through investments in systems and operational and service infrastructure.

Innovative solutions, such as the web-based point of sale and online administration system offered by FWU Group, have facilitated the sales process through the branch banking network with proprietary software simplifying online customer

application, policy issuance, policy administration and management information reporting

Developments in Islamic asset management

A key factor contributing to Takaful expansion is the continuous growth in Islamic finance within all its components. The total size of the Islamic funds industry was estimated at about US$58 billion in 2010 globally (a growth of 13% from 2008) according to the latest Ernst & Young Islamic Funds & Investments Report 2011.

Islamic asset management has seen a shift away from the mainstream asset classes of equity and real estate. A number of structured products and new funds have been introduced recently including Shariah compliant exchange-traded funds (ETFs).

In coming years, we can certainly expect a proliferation of sophisticated Shariah compliant instruments that will create more investment opportunities for Takaful operators, and boost further Takaful growth and profitability.

Regulatory developments

A number of countries continue to adjust their regulatory environment to facilitate the integration of Takaful and promote its growth through appropriate amendments in legislature.

In Malaysia, the Takaful Operational Framework came into effect in January 2012 with the objectives of enhancing Takaful business efficiency, ensuring healthy and sustainable Takaful funds and safeguarding participants' interest. Bank Negara Malaysia also issued a draft risk-based capital framework for Takaful operators which aims to address solvency requirements described in the IFSB 'Standard for Solvency Requirements in Takaful Undertakings'.

In Pakistan, the Securities and Exchange Commission issued draft Takaful rules proposing significant changes in the Takaful regulatory framework allowing conventional insurers to operate Takaful windows.

In the GCC, one major development has come from Oman, which recently joined the ranks of Takaful when the Capital Market Authority (CMA), the national regulator, granted approval for the first Takaful operator in the country, Al Madina Gulf Insurance. The market might however take time to pick up, as only fully-fledged Takaful companies will be allowed to offer Shariah compliant products. Islamic windows for conventional insurance companies are not permitted in the sultanate. The CMA is in the process of finalizing the regulations and standards required for Takaful operations.

In the UAE, the Insurance Authority issued a circular in September 2011 to all insurance and Takaful companies setting out guiding rules that they should adhere to for their Bancassurance business.

Another GCC regulatory development was seen in Saudi Arabia. The Saudi Arabian Monetary Authority (SAMA) directed all operators to align with the cooperative insurance model by the end of 2011. Takaful operators had to adjust their internal accounting structures, remove the use of Wakalah and Qard and amend product terms and conditions. This shift away from the pure Takaful model may have various effects on the industry, especially as Saudi Arabia is to date the largest Takaful market globally.

Morocco, the only country in the Maghreb that doesn't offer any Takaful products yet, has shown tremendous progress in promoting Islamic finance. A new set of rules and regulations is being finalized, and the first fully-fledged Islamic bank is planned for 2013.

> **"Rising competition is creating a price war between young Takaful operators and established ones which is challenging profitability"**

Conclusion

Despite the positive outlook for Takaful and the considerable expansion of the businss, the industry remains concentrated in limited markets, segments and business lines. Industry data is showing a slowdown in growth rates, putting increasing pressure on the operators to boost efficiency, roll out new products and explore new markets.

The industry's main challenges include the development of customer-centric products and more distribution capabilities as well as improving operating efficiencies. Building consumer awareness especially about the importance of long-term savings is also crucial to the promotion of Takaful.

Rising competition is creating a price war between young Takaful operators and established ones which is challenging profitability, which still remains below rates achieved in conventional insurance. Takaful operators are also faced with the preparation for Solvency II implementation and the applicability of IFRS4 and IFRS9 which will require special systems and infrastructure adjustments.

The industry is entering a stable development stage, although a number of key issues still need to be tackled to unlock the true potential of Shariah compliant insurance as a value driven, Shariah neutral offering.

FWU Global Takaful Solutions
Al Fattan Currency House Building
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Shariah compliant UCITS to satisfy the appetite of international investors

One outcome of the global financial shocks of the past five years has been a shift in the nature of investors' demand. The priority now is to access investment products and solutions that are less volatile, with comparable risk-adjusted returns.

There is an emergence of a new investment trend. International investors are exploring alternative assets and investment processes that are socially and financially ethical, that are managed transparently and that are robustly regulated. These investors are also searching for investment products to diversify their portfolios internationally and across multiple asset classes. However, the availability of such products and solutions is in short supply and they are not easily tracked or widely offered internationally.

The current supply of existing domestic-centric ethical mutual and unit trust funds, in the format of existing Shariah compliant investment funds, is not appealing to international investors due to the following:

1. Most Shariah compliant funds cater to the domestic market where the funds are meant for investors in that country. These funds are generally small and issued only in the home currency and foreign investors can view that as an impediment. They would prefer the fund base currency to be an internationally accepted currency like the US dollar or euro.
2. Small fund sizes result in investor concentration risk and can be illiquid.
3. Too short a Shariah investment track record to grant confidence.
4. Fund performance figures are generally not calculated according to Global Investment Performance Standards (GIPS).
5. A domestic fund may not have internationally acceptable Shariah interpretations.

Investment solutions that can mitigate the above concerns do exist, albeit on small scale, in the form of Shariah compliant UCITS funds. The Undertakings for Collective Investment in Transferable Securities (UCITS) fund structure was initially designed as a European regulatory 'passport' in order to sell funds across the European Union, and its acceptability has now expanded to other regions around the world, including Latin America and Asia. These types of funds are available in regulated offshore fund platforms like Ireland (Dublin) and Luxembourg.

Global UCITS fund platforms are structured to appeal to international investors, given the robust risk framework and strict governance. The UCITS structure is flexible enough that it can be offered in multiple asset classes and multiple currencies to a broader investor base. As such, it can more easily build scale internationally. Such platforms are popular in the conventional space and Islamic asset managers would do well to take full advantage of these platforms to structure international Shariah products.

> "Saudi Arabia, the UAE and Bahrain. Saudi Arabia currently has the highest Islamic fund assets under management in the world at US$19.9 billion"

Bringing Shariah investment to a global audience

Acknowledging the increasing need to provide cross-border solutions, CIMB-Principal Islamic Asset Management (CIMB-Principal Islamic) established a UCITS funds platform in Ireland in December 2011, the first Malaysia-based Islamic asset manager to do so. CIMB-Principal Islamic has launched three Shariah UCITS funds – the Islamic Global Emerging Markets Fund, Islamic Asia Pacific ex-Japan Fund and Islamic ASEAN Equity Fund - for international distribution. These three capabilities were identified based on market research which revealed the growing investor demand for these investment strategies which are not widely available on a UCITS fund platform today.

In the case of global emerging markets, the International Monetary Fund (IMF)'s prediction was a higher economic growth rate of an estimated 5.5% for this region in contrast to a miniscule growth projection of 1.2% for the developed markets. With the prospect of higher returns on the back of higher underlying growth and improved risk relative to the developed markets, it is easy to see why international investors are seeking higher exposure to the emerging markets asset class. Improved economic and financial stability, continued solid economic growth prospects and rapid per capita growth will drive solid asset growth, not only in dollar terms but also as a share of total global GDP. Investors will benefit from the emerging markets share in world output in US dollar terms which is set to exceed 40% of world GDP by 2016, driven predominantly by strong Asian growth .

Asian economies are expected to continue to lead the global recovery, with a projected economic growth of 7.5% in 2012. Domestic demand in Asia has proven generally resilient in 2011. Employment gains and real wage growth supported private consumption, and high capacity utilization boosted private investment. Financial policies have remained accommodative in most of Asia, as increases in interest rates were offset partly by higher inflation in some economies. The Asia Pacific ex-Japan region is expanding capital investment and consumption due to rapid urbanization and industrialization, and will continue to do so for the foreseeable future. It is said that more than half the world's middle class may reside in Asia by 2020.

The Association of Southeast Asian Nations (ASEAN) region is also well-placed for long-term growth. The ASEAN region is the third most populous area globally. Its current population of about 596 million, or 8.8% of the world population, is expected to reach 710 million by 2030. The ASEAN Economic Community aims to transform ASEAN into a single market and production base with free flow of goods, services, investment, skilled labor and capital. Between now and 2020, ASEAN is expected to add 65 million people while Europe is expected to shrink by 8.5 million people. Within two decades, ASEAN is anticipated to have a larger and younger population than a shrinking and aging Europe.

CIMB-Principal Islamic intends to offer its Shariah compliant funds in seven jurisdictions. The identified markets in Europe are the UK, Switzerland and Germany. The UK is the Islamic finance industry leader in Europe with a sizeable Muslim population while Switzerland is synonymous with its private bank industry. In the Middle East, the funds will be available in Saudi Arabia, the UAE and Bahrain. Saudi Arabia currently has the highest Islamic fund assets under management (AUM) in the world at US$19.9 billion.

The UAE and Bahrain are both recognized for their vibrant Islamic finance industries. In Southeast Asia, the funds will be available in Singapore, in order to enable high net worth individuals in Brunei and Indonesia to invest more easily. Singapore has demonstrated its ability to capture investors in the conventional fund space who invest in Ireland and Luxembourg-domiciled UCITS funds.

In tandem with the demand sought by international investors, these three funds will offer two asset classes, retail and institutional, and will be made available in two major internationally accepted currencies, the US dollar and the euro. Investors can rest assured these CIMB-Principal Islamic funds adopt industry best practices, within a defined and prescriptive governance and risk management regime.

Shariah compliant UCITS funds available globally but with limited strategies

Although Shariah compliant UCITS Funds are available globally, there are only a total of 26 Islamic UCITS in both Luxembourg and Ireland . Shariah compliant UCITS funds were first made available to international investors on global fund platforms like Ireland and Luxembourg since 2000. However, the majority of the available funds were launched from 2008 onwards.

It is interesting to note that Shariah compliant UCITS funds that currently exist on these global fund platforms were established by conventional global asset managers from non-Islamic countries: the US, Germany, the UK, France, Australia and Switzerland. These conventional global asset managers are the obvious initiators that investors are comfortable with. With their proven track record, some spanning 50 years, these asset managers have the confidence of their investors in the conventional mutual fund space. It therefore makes a lot of sense that this trust, and hence additional investment, is extended to newer products like their Shariah investment offerings. We can find such Shariah compliant UCITS funds by these managers mainly in Ireland and Luxembourg, where they have had a full complement of conventional UCITS funds available for many years.

For investors looking to invest specifically in Shariah compliant equities on the UCITS fund platform, the widest selection is in global equity UCITS funds. For investors keen to invest in global Sukuk, there is only one available fund in Luxembourg; however, this fund is not UCITS-compliant. The breakdown of these fund strategies in Luxembourg and Ireland are as follow:

Funds in Luxembourg and Ireland	
Strategies	**Number of Funds**
Global Equities	7
European Equities	4
Global Emerging	3
Global Resources	2
BRIC	1
Japan	1
Asia Pacific ex-Japan	1
Others	7
Total	**26**

Investors should not be unduly concerned about the low fund size, averaging US$20 million. We believe many of these funds were constructed to serve as an incubator strategy by the fund houses to build sufficient track record of three to five years to showcase their investment management ability. By 2013, we expect the size of these funds will grow exponentially as they cross the five-year mark, granting confidence to investors that are currently tracking the performance.

MIFC encouraging its licensed Islamic asset managers to offer UCITS

To reinforce the importance of those cross-border offerings, the Malaysia International Islamic Financial Cener (MIFC) is encouraging its 17 Islamic asset management houses to internationalize their product offerings and enhance the visibility of its Islamic funds among global investors by establishing and incubating their own Shariah UCITS funds as well. Investors are therefore encouraged to be on the lookout for Shariah UCITS funds by MIFC-licensed asset managers going forward.

Taking cognizance of the potential scalability of Shariah compliant UCITS funds, this initiative is taken seriously by MIFC, to the extent that an MoU between the Securities Commission Malaysia (SC) and the Central Bank of Ireland was signed in November 2011. The MoU provides an arrangement for the two regulators to exchange information and cooperate in the area of regulation and supervision of authorised entities offering collective investment schemes. The SC also signed a similar MoU with the Commission de Surveillance du Secteur Financier (CSSF) of Luxembourg in January 2012.

Shariah investing is resilient in bull and bear markets

Through a global fund platform, institutional and retail investors can track Shariah funds transparently via international investment research providers like Bloomberg, Thomson Reuters and Morningstar. An internationally visible track record would definitively help to debunk the myth that Shariah compliant investments underperform the conventional investments. Over various time periods Shariah compliant funds have broadly matched or in some instances even displayed comparable performance with conventional funds even through adverse global economic conditions.

On a global basis over the six years ending December 2011, the Dow Jones Islamic Market World Index outperformed its conventional counterpart, the Dow Jones Global Index, 38.55% to 22.91%: a cumulative outperformance of 15.64%. For Asia Pacific ex-Japan, the Dow Jones Islamic Market Asia Pacific ex-Japan Index outperformed the conventional Dow Jones Asia Pacific ex-Japan Index, 30.95% to 22.65%, a cumulative outperformance of 8.3% during the same period . Without an international shop window for Shariah compliant funds to showcase their outperformance to investors, this common misconception persists.

UCITS: An ideal platform

Investors in Shariah compliant UCITS funds will be reassured by a regulatory framework that is clear, straightforward and easily understood. They can also take comfort that fund managers supervised under this regulatory framework must adhere to investor protection, transparency and disclosure requirements. It offers investors industry best practices making it acceptable globally and introduces a more defined and prescriptive governance and risk management regime.

A UCITS fund is able to accommodate investors of all stripes within a single fund. Therefore, whether investors are retail, high net worth or institutional, they will enjoy different fee levels and be subject to different requirements. In addition, such a fund can be available in multiple international currencies, making it more convenient for investors. Having different investors in one fund also results in a larger asset under management. This will reduce the Total Expense Ratio of the fund, for onward benefit to each of their international investors.

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CIMB Principal
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CIMB-Principal Islamic Asset Management

Winner of

Best Overall Islamic Asset Management Company & Best Islamic Asset Management Company In Asia

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Noripah Kamso is the chief executive of CIMB-Principal Islamic Asset Management (CIMB-Principal Islamic). Since 2008, she has successfully established a global platform for the firm to extend its reach across the globe. The firm acts as a global partner to global institutional investors, providing a range of Shariah investment portfolios to suit differing investment needs.

The firm offers global capabilities in equities and Sukuk to institutional clients like central banks, pension houses, Takaful and SWFs. Besides being a dedicated end-to-end Shariah global house, the firm has also been GIPS compliant since December 2009.

Previously she served as CEO of CIMB-Principal Asset Management (CIMB-Principal) which evolved from a Malaysian company to a regional asset management house with offices in Malaysia, Indonesia and Singapore.

She was deemed a two-time winner of the "Marketing Personality of the Year" award (for 2005 & 2006) by Asia Asset Management for the Asia Pacific region and CEO of The Year for Malaysia (2007). Besides serving as a council member of the Federation of Investment Managers Malaysia (FIMM), she was the past president of the Malaysian Futures Brokers Association (MFBA).

A great believer that Islamic investing is resilient whether in bear or bull markets, Noripah has successfully lead CIMB-Principal Islamic's further expansion into global markets in support of Malaysia's aspiration to be a global Islamic financial hub. Acknowledging that Islamic asset management is an infant industry, she takes it as her responsibility to continuously share her thoughts and research via numerous article contributions in global publications as well as at international Islamic finance and Takaful conferences in UK, Europe, GCC, Asia, USA and Australia. This fine leadership persona has led to the company's global recognition by the best industry awards.

Takaful and Waqf: An ideal partnership?

Mention the word Waqf and most people will think of a mosque, a Madrasah, a charitable organization or other religious institutions, buildings or land. This perception is correct, but not entirely complete.

The Waqf has been in existence even before the rise of Islam, but Islam gave it its legal status. When the prophet Muhammad first migrated to Madinah, he built the Quba' mosque as Waqf, to serve as a place of prayer for Muslims. The Prophet and his Companions continued to bequeath other property as Waqf: including land for travellers, wells for drinking water, weapons for self-defence of the nation and many others.

As Islam spread and grew, the institution of Waqf expanded to include almost all the socio-economic needs of Muslims. Waqf grew to encompass not only traditional mosques and Madrasahs, but also public infrastructure such as roads, universities and other institutions of learning, agricultural land, and even money.

The institution of Waqf, in fact, played a significant role in the development of the Ottoman Empire, as it provided much needed income and services to the nation.

What is Waqf?

It is "the holding and preservation of a certain philanthropy – Sadaqah (charity) – with the intention of prohibiting any use or disposition of the property outside the specific purposes to which the property is dedicated, in such a way that it cannot be bequeathed or sold". Although most forms of Waqf have been traditionally movable or immoveable physical properties, the cash Waqf is an innovation presumed to have been created in the 15th-16th century under the Ottoman Empire.

A cash Waqf fund, as the name implies, is created with liquid money. The fund is invested, and returns from the investment are used for the specific purposes determined by the founder. As in all other forms of Waqf, a deed or fund rules will dictate how the fund will be administered and who the beneficiaries will be. The cash Waqf seems to be more practical in modern-day context as it is relatively easier to set up and accessible to most individuals.

How is Takaful used together with the Waqf?

The Wakalah-Waqf model has been developed for this purpose. As the name implies, it is a combination of the Wakalah model for Takaful with a Waqf. It is already being successfully used by re-Takaful operators in Pakistan and South Africa, and by Swiss Re ReTakaful. The Wakalah-Waqf model's main value proposition is that it resolves the issue of ownership of the Tabarru' fund. This issue has been a main point of disagreement between Shariah scholars. The model works similar to a pure Wakalah model in most aspects. However, a cash Waqf is created to serve as a separate Shariah entity that will be the center of the relationship between the participants and the Takaful operator. Briefly, here is how the model works:

- The Takaful operator creates a cash Waqf fund with an initial donation, for the purpose of extending financial assistance to its members in the event of losses.
- The Waqf fund has the characteristics of a typical Waqf: for example, it is inalienable, irrevocable and exists in perpetuity.
- The rights and obligations of all parties are spelled out in the Waqf deed or fund rules, and will be agreed to by all participants who wish to become a member of the fund.
- The Takaful operator acts as a Wakeel to administer the Waqf in accordance with the fund rules.
- Members of the fund agree to relinquish a certain amount of money without condition as Tabarru', and will receive benefits in accordance with the fund rules.
- Any surplus sharing and distribution will also be specified in the fund rules.

> **"The Wakalah-Waqf model's main value proposition is that it resolves the issue of ownership of the Tabarru' fund"**

In this case, ownership of the Tabarru' clearly belongs to the Waqf. Thus, any ambiguity is removed as a Waqf has the ability to accept ownership of an asset. Since the Tabarru' is an unconditional donation, participants lose any rights of ownership to their contributions. However, the relationship is not fully unilateral, as the participants' rights to any benefits and surpluses are clearly spelled out in the fund rules.

It is important to note that while the Waqf gains ownership of the Tabarru' contributed by the participants, the value of the Waqf itself does not increase. Therefore, the Tabarru' can be used for claims payments and surplus distribution.

Advantages of the Wakalah-Waqf model

The Wakalah-Waqf model for Takaful has its advantages. While the main value proposition of the model at present is its ability to resolve the issue of ownership, the institution of Waqf has been used to great advantage in meeting society's many socio-economic needs. Scholars are currently looking at how Waqf can rejuvenate its role as a contributor to the development of a country or society.

Likewise, the potential use of Waqf in various other aspects of Takaful has yet to be fully explored. Issues that can be looked into include developing pension products, defining other types of benefits that would otherwise be difficult under the Wakalah model, and linking these benefits to charitable uses, to name a few.

Conclusion

Takaful and Waqf are complementary, in the sense that they both provide benevolent relief or benefits to beneficiaries, albeit through different instruments. Perhaps it is time for practitioners and scholars to more closely study the relationship between Takaful and Waqf, to produce a truly Shariah-based solution to society's needs.

Swiss Re

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Islamic terms and what they mean

***Takaful**: The Islamic equivalent of insurance, based on Shariah law, whereby a group of participants contribute money into a pool, to guarantee one another against loss or damage.*

***Tabarru'**: Donation. In the case of Takaful, the tabarru' fund is the equivalent of the risk fund in conventional insurance.*

***Wakalah Model:** The 'Wakalah contract' refers to a contract of agency. In a Takaful Wakalah model, the Takaful operator acts as an agent for the participants, and receives a Wakalah fee as compensation for managing the Tabarru' fund on their behalf.*

***Wakeel**: Agent*
Wakalah Waqf model: It is a Takaful operating model that works in a similar way as the Wakalah model, but has a separate entity of Waqf in between. It requires the setting up of a Waqf fund through an initial donation by the re-

***Takaful operator**. The Waqf fund becomes the nucleus for the relationship between the participant and the operator, i.e. both have obligations and rights towards this Waqf which are described in the fund rules.*

***Shariah**: Islamic religious law.*

The global Islamic debt market: Has it reached a plateau?

The general public and many conventional bankers have traced the adoptability of Islamic finance via the growth of the Sukuk market, and in many ways it has become the benchmark for the usability of Islamic finance by practitioners in the conventional financial system. ADERI ADNAN, the Islamic finance and banking advisor of LIBFC, shares his thoughts.

More than 20 years from the world's first corporate Sukuk issuance, many are asking if the heady growth of the Islamic debt market has waned and if this is a sign of the general demise of Islamic finance? Or is it merely symptomatic of the global market conditions, which confirms the inter linkage between the conventional and Islamic financial systems?

Clearly, over the years the Islamic debt capital market has demonstrated its capability as a viable alternative avenue for financing, with some traditional European financial markets attempting to find their place in this market by introducing legislation to facilitate the issuance of Sukuk.

Notwithstanding, Malaysia and certain states in the Gulf Cooperation Council (GCC) have stood their ground, maintaining their distinct leadership in the industry, aptly supported by a deep-rooted understanding of the dictums and philosophy of the religion.

Domestically, the first quarter of 2012 alone has been peppered with landmark Sukuk deals: for example Projek Lebuhraya Usahasama Berhad (PLUS)'s successful issue of RM30.6 billion (US$9.97 billion) Sukuk. PLUS is the largest toll road company in Asia and its Sukuk program represents the world's largest Sukuk issuance.

Another sign of the dynamic nature of the Malaysian Sukuk market is the increased size of the Sukuk offering by Sarawak Energy, also issued in January 2012. Due to strong investor demand, the planned issue was almost doubled from RM1.5 billion (US$488million) to RM2.5 billion (US$814 million). At the close of offer, the order book stood at RM6.2 billion (US$2 billion).

The outlook for the rest of 2012 remains bright and it is expected that the total Ringgit issuance for 2012 will be in the range of RM50-60 billion (US$16.3-19.5 billion), representing 65-70% of total global Sukuk issuances, maintaining Malaysia's leadership in the global Sukuk market.

If the growth of the Sukuk market in Malaysia is a barometer for the wider market, then it is clear that the Islamic debt market is nowhere near its peak, even though it might have taken a breather in the years directly following the credit crisis. This recent slowdown is only to be expected as Islamic finance does not and should not exist in a vacuum; in fact it is a clear testament to the linkage between the conventional and Islamic financial systems.

A symbiotic relationship between conventional financing and Islamic finance is one of the key prerequisites for the latter, in order for it to grow into a realistic alternative to conventional financing. The fact that Islamic financing is the world's oldest form of ethical financing also works in its favor, allowing it to reach out to the non-Muslim audience.

Clearly, the future of the Islamic debt market is set for even greater growth especially when one considers:

- **The positive outlook for GCC States**

Of late there has been a substantial upswing in the amount of corporate spending in the Gulf coupled with an increase in issuers seeking to diversify their sources of funding. This coupled with improving investor sentiment in the Gulf is expected to further fuel fundraising activities.

In the aftermath of Dubai's debt restructuring and high profile Sukuk defaults, there is now an enhanced approach to managing risk in the region and confidence is returning. As a result, renewed investor confidence is emerging and along with the fact that oil prices above its five-year average, the demand for Sukuk offerings in the Gulf is reaching a new height.

The region is also experiencing a slew of sovereign fund-raising efforts to support economic growth and the revival of private sector projects, which in turn provides a strong growth base and a bright future for the Islamic debt market.

- **The increased inflows into emerging markets**

As economic growth in the developing and emerging markets continue to outpace that in the developed markets, it is inevitable that there will be an increase in the inflow of funds into these regions, many of which are traditionally centers of Islamic finance.

Over recent years this has been evidenced as we have seen demand exceed supply at recent sales of Islamic bonds in Malaysia and the Persian Gulf, reinforcing positive market

sentiment in the region and confirming that numerous Shariah compliant funds have surplus cash to invest.

It is clear that there are many Shariah-based funds looking to tap the Islamic bond market. Another example is Qatar Islamic Bank's USD$750 million Sukuk, which was also oversubscribed, again clearly demonstrating the growing appetite of this burgeoning market. Undoubtedly, Asia and the Middle East are markets which will continue to attract a range of Shariah compliant investments, especially as market conditions compel them to seek safer havens for their investments.

- **The innovation of new products within Islamic finance**

As the overall Islamic fund pool increases and the financial flows across borders also increase, it is only natural that the management of these funds will naturally become more efficient and will contribute toward the development of Islamic instruments.

Over the next few years, the emergence of new asset classes, improvements in Shariah screening methodologies, improved risk management mechanisms as well as the application of innovative new concepts to more common or familiar Sukuk structures will spur an expansion of these financial instruments.

To a certain extent this can be seen today, for example the Qatar Exchange is looking to launch a secondary market for bonds and Sukuk, whilst the Bahrain Financial Exchange intends to set up a 'Bait al Bursa' for Shariah compliant products.

In addition, the commencement of operations by the Kuala Lumpur-based International Islamic Liquidity Management Corporation with the issuance of liquidity instruments sometime in 2012 will do much in internationalizing Islamic finance by supporting cross-border transactions via the introduction of effective short-term liquidity management tools.

- **The emergence of non-traditional Sukuk-issuing jurisdictions**

It is estimated that whilst Malaysia will maintain its dominance in the global Sukuk market in 2012, issuing more than 60% per cent of all Sukuk worldwide, there are many other countries and corporate issuers which are now venturing into this form of debt financing.

For example, Pakistan is expected to launch an a three-year PKR45 billion (US$496 million) government Sukuk Ijarah, Indonesia will issue in 2012 a cumulative Sukuk issuance of over IDR200 trillion (US$22 billion), and Senegal will launch a debut sovereign Islamic bond of around US$200 million. Other countries vying to issue either a sovereign Sukuk or a corporate Sukuk include Russia, Egypt, Kenya, and South Africa. Clearly the level of global interest is significant.

In addition, several European countries including the UK, France and Luxembourg have introduced enabling legislation to facilitate the issuance of Sukuk. This is seen as a major endorsement of a financial system which up to three years ago was considered 'alternative' within the conventional financial circles.

As the number of issuers increase, so will the depth of the market and this will lead to greater familiarity and acceptability. It is hoped that with time the Islamic debt market will be accepted as part of the global financial system.

The Malaysian value proposition

Malaysia is among the pioneering jurisdictions that have successfully developed and incorporated Islamic finance into its modern financial system. Malaysia's Islamic finance infrastructure coupled with Labuan IBFC's regulatory strength and favorable business environment for Shariah compliant business, has paved the way for Labuan IBFC's leadership in Islamic finance.

In addition, the Labuan Islamic Financial Services and Securities Act 2010 has been a landmark achievement for Labuan IBFC as it has clarified, streamlined and consolidated all Islamic finance related issues into one piece of legislation.

> "The acceptance of Islamic financial services as a viable alternative to the conventional system will increase and with it, the Islamic debt market is set to take off on a new growth trajectory"

The Act has meant that Labuan IBFC is one of the few financial centers catering to the specific requirements of each segment of the Islamic financial services industry, covering the entire spectrum of services from banking, Takaful, reTakaful, Sukuk issuance, wealth and fund management.

This provides a greater degree of comfort for investors and issuers involved in Islamic financial services whilst ensuring compliance with Islamic Shariah principles.

Against the backdrop of a recovering global economy, we believe the acceptance of Islamic financial services as a viable alternative to the conventional system will increase and with it, the Islamic debt market is set to take off on a new growth trajectory.

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Effective engagement

Global Takaful contributions grew by 19% to US$8.3 billion in 2010, dominated by the GCC at US$5.68 billion. However, the Takaful market is still considered to be very much under-represented relative to the sheer size of the global Muslim population. NAZNEEN HALIM examines the current distribution channels.

It is undeniable, particularly in the Takaful sector, that the customer is king. However, for an industry which is essentially retail-based there is still much lacking in terms of identifying the most effective forms of distribution and creating awareness on a grassroots level. The potential for Takaful penetration on a global scale is massive, considering the growing numbers of Muslims which are actively seeking Shariah compliant alternatives of investing, as well as an increasingly curious non-Muslim population enticed by less risky investment options.

The numbers have so far been encouraging in terms of Takaful growth and penetration, but admittedly much more needs to be done in order to fulfil the statistical growth projections; particularly in Muslim majority countries. A market player revealed: "For countries with high Muslim populations, Takaful market penetration is expected to surpass the conventional rate in the next five to 10 years with the right strategies in place. Statistics have indicated that a significant portion of the population in these countries consists of those aged 35 years and below who are educated and IT savvy. This could potentially lead to higher demand for products like Takaful in the near future."

Distribution channels

At present, BancaTakaful is still the preferred mode of distribution for most Takaful operators. However, agency-based distribution is fast gaining ground across the board, and has been identified as a relatively more efficient form of distribution.

According to industry players, agency distribution allows players to reach a wider customer base at lower management expenses, with the Wakalah fee paid to agents also factored in the pricing of Takaful products. Takaful providers such as Takaful Malaysia for instance, utilize six main distribution channels: including retail and corporate agency forces, BancaTakaful, corporate direct channels, brokers and treasury business channels.

According to the central bank of Malaysia, Bank Negara Malaysia, the number of Takaful agents has more than quadrupled in the last five years, from 11,000 in 2006 to 55,000 in 2010, and continues to see a steady increase. According to Azim Mithani, CEO at PruBSN Takaful, agency distribution will further enhance the penetration rate of Takaful in the local market as it allows operators to access a wider segment of the population and "enjoy economies of scale". He added that significant investments are required to establish an agency channel, which involves the recruitment and training of agents, as well as maintaining the infrastructure.

"It is vital to ensure that agents are properly equipped and trained to provide the necessary advice. Therefore, appropriate compliance and risk management standards need to be put in place. PruBSN has established a dedicated training academy to provide comprehensive training to agents as well as rigorous compliance monitoring processes."

Other industry players also concur that in terms of quality of advice to policyholders, service and need-based risk management, the agency model is a more sustainable channel in the long-term, especially for regular premium protection products.

However, BancaTakaful is still expected to play an important role in the distribution of Takaful products as it provides economies of scale, whilst agents are more effective in penetrating the non-Muslim customer demographic and in expanding both Family and General Takaful product lines.

Technology is also fast becoming an important element in enhancing cross-border distribution of Takaful products, according to Bakarudin Ishak, the assistant governor of Bank Negara Malaysia. "Moving forward, the Takaful industry has to seek the best solutions to propel its growth at a faster pace. Efficiency and strength can be achieved through investments in systems and technology. A more advanced back-end system and up-to-date structured information retention and data mining system will allow operators to conduct more comprehensive analysis to understand its target market better," he said.

Fund woes?

The Takaful industry possesses considerable potential in the mobilization of funds and primary market activity, and is touted to be a major growth driver in the industry moving forward. So why has this not happened yet? NAZNEEN HALIM explores.

The Takaful industry is said to have hit 19% growth since 2010, and there are a growing number of Takaful investment accountants looking at the amount of money needed to deploy instruments for the development of the market in various regions. Countries such as Malaysia, Saudi Arabia, Sri Lanka and the African continent have been touted as the next big things in the Takaful industry, and the GCC region has also seen the emergence of new Takaful companies despite the global economic crisis.

The industry's greatest challenges include building product awareness and making consumers realize the importance of saving over the long-term. An alternative to conventional insurance, Takaful is based on the concept of mutuality; the Takaful company oversees a pool of funds contributed by all policy holders, but does not necessarily bear risk itself. In their investments, Takaful firms must follow religious guidelines, including bans on interest and pure monetary speculation, and a prohibition on investing in industries such as alcohol and gambling.

However, its product categories are similar to conventional insurance, with family coverage, equivalent to life insurance, and general coverage, equivalent to property insurance, accounting for most business.

The Breakdown

Takaful is ultimately based on the concept of shared responsibility, shared guarantee, collective assurance and mutual undertakings.

Therefore, Shariah compliant insurance is based on shared responsibility, mutual cooperation and solidarity and is designed to protect the participant against a defined risk. There are generally four parties involved in a Takaful operation: Participants, who contribute the premium to the fund; the operator, who is a licensed body who manages the fund according to Shariah principles; the insured, who are the participants who face the risk and are assisted by the fund; and the beneficiaries, who are those who benefit from the fund.

The two Takaful models commonly seen in practice are the Wakalah or agency model, and the Mudarabah model, both of which are based on the form of the relationship between participants and the operator. In the Wakalah model, the operator acts as an agent of the participants of the Takaful funds and is paid an upfront fee to cover operational expenses of the fund. The surplus in the Takaful funds, if any, after the operator's fee, belongs to the participants. The operator's fee, which is sourced from fund, is determined in advance with input from the company's Shariah committee.

Meanwhile, in the Mudarabah model, participants are entitled to a share of the profits only when the company is profitable. The investment returns and underwriting profit are shared with the operator. The basis for the profit sharing is according to a predetermined sharing ratio which has been approved by the Takaful company's Shariah committee. In this regard, Takaful is regarded as a profit sharing business venture between the participants and the operator.

The market opportunity is significant, according to a report last year by Swiss RE, with conventional insurance accounting for an estimated 83.1% of all premiums written in Muslim countries. Azim Mithani, CEO of Prudential BSN Takaful, is also banking on Islamic insurance to create real market activity.

The Malaysian market, he says, is ripe for the picking. "We see enormous opportunity in the Takaful industry in Malaysia. With the Malaysian economy rebounding strongly from the financial downturn in 2009, its attractive demographics

and growing affluence, there is tremendous potential for the industry. Takaful net contributions have increased from US$421 million in 2005 to US$1.1 billion in 2009, and we are very confident that the industry will show equal strength in years to come. Increased liberalization measures by the government will continue to reinforce Malaysia's position as an international Islamic finance hub.

This, along with the recent issuance of four new family Takaful licenses, will drive further innovation and competition, thus benefiting the consumer - the ultimate user of our products and services," he added.

However, despite the massive potential within the industry, the serious need for long-term investments, specifically for Takaful participation fundholders for Family Takaful, is becoming increasingly apparent and is considered a major hindrance to the industry's growth. An industry player revealed: "This has been an issue for a long time, and long-term Sukuk is the only facility able to fulfil that gap. Sukuk will eventually become a force to reckon with within the industry.

However, most of the papers we see now are still short-term. As we progress, there will be longer-term Sukuk which is ultimately what the Takaful industry needs. These long-term investments are needed for the participation fund liabilities, and because many companies are new and young, their participation funds are not that big in terms of scale, and Sukuk when floated in the market can only be bought in large chunks. And these new companies do not have access to that amount of money.

"The industry ultimately needs to have managed Sukuk funds, where Takaful companies can ease in and ease out of the amounts of investments. This sort of innovation is needed to enable Sukuk availability for the long-term products.".

Development, growth and challenges of Takaful in Malaysia

Up until 33 years ago, both Muslims and non-Muslims had only one means of insurance protection: that is, via the conventional insurers.

Today, the world has witnessed the emergence and development of Takaful which is often viewed and perceived myopically as synonymous with Islamic insurance.

The formation of the first Takaful company in 1979 in Sudan was the a culmination of a historical legacy dating back as early as the sixth century when the system of Al-Aqila, as practised by the pagan Arabs, was approved and used by the Prophet (S.A.W) in his judgment in solving a dispute between two women from the Huzail tribe.

Documents enunciating the Aqila principle were also found in the Constitution of Medina written in 622 AD with which disbursement will be made to victims of accidental murder, to those who lost their belongings, etc. Besides the Al-Aqila scheme, there were also the Al-Qasamah and the Al-Muwalah schemes. These schemes worked on the principle of communal mutual coopration which is known as Takaful Al-ijtimai.

In fact, as narrated by historians, this form of Islamic insurance existed in the early part of the second century Hijrah. It was then adopted by the traders plying between Arab countries to India and the rest of Asia. Later these concepts were adopted by the Europeans and named marine insurance as indicated by the Italian who boasted about their so-called first known 'insurance agreement' executed in Genoa on the 13th October 1347. In business, this concept of mutual cooperation against losses and calamities is commercially known as Takaful Al-tijari.

Development in Malaysia

In Malaysia, on the 15th June 1982, the Majlis Fatwa Kebangsaan (National Fatwa Council) deliberated on the question of life insurance. By consensus, the members of the Council decided that life insurance as practised by insurance companies is a 'Fasid' (defective) transaction as it is contrary to the Shariah principles of contract. Subsequently in 1982, the working committee (Badan Petugas Khas) set up an Islamic Consultative body to study the formation of an Islamic insurance company in Malaysia and recommended the formation of Islamic insurance institutions which are now known as Takaful companies.

The decision of the jurists was to formulate the Takaful program in agreement with the Shariah legal maxim: "All things originally are permissible unless there is evidence to prove their prohibition." This principle, agreed by all Muslim scholars, is that the financial instruments that exist in the current economy and the benefits derived from them are essentially for man's use and as such are permissible. Accordingly, the Quran as stated in Surah Luqman ayat 20 (31: 20):

"Do you not see that Allah has subjected to your (use) all things in heavens and on earth and has made His bounties flow to you in exceeding measure, (both) seen and unseen? Yet there are among men those who dispute about Allah, without knowledge and without guidance, and without a Book to enlighten them!"

To legislate the activities of Takaful, the government of Malaysia introduced the Takaful Act 1984 which formally regulates and oversees the development and transactions of the Takaful business so as to run in parallel to the existing insurance industry.

The development of Islamic insurance in Malaysia has thus far evolved in a three-phase cycle. The first evolutionary phase back in the 1960s and 70s saw a surge of Islamic fervor and called for the establishment of an Islamic financial system. Scholars and Muslim jurists in many parts of the world discussed and put forth the idea of introducing an Islamic financial system which as interest-free and uncertainty-free: that is, Shariah compliant.

Then came the second phase, the nurturing phase, which took place during the 1980s. It was during this phase that some of the fundamental infrastructure, namely the Islamic Banking Act of 1983 and the Takaful Act of 1984 (the only one of its kind in the world), were formulated. Subsequently came the first prototype models of Bank Islam in 1984 and Syarikat Takaful Malaysia in 1985. Their existence remained unperturbed for many years, perhaps due to the fact that the government wanted to ensure that the Islamic system rudiments were given a fair chance to grow and be on a sound footing.

The 1990s and the early years of the 21st century witnessed another phase in the development of the Islamic financial system in Malaysia. This so-called consolidation phase saw the emergence of competitive elements within both the Islamic banking and insurance sector. Conventional banks were allowed to introduce 'interest-free banking' windows and Bank Negara Malaysia also issued more new Islamic bank licences. Twelve new Takaful licences were also issued to MNI Takaful (later known as Takaful Nasional and now known as Etiqa Takaful), Mayban Takaful, Takaful Ikhlas and others. The presence of these new players introduced competitive forces into the marketing environment which in turn influenced both marketing and consumer decisions and activities. The competition spurred more vigorous marketing activities in the form of more varied products, more promotions and competitive prices.

Growth

Today there are more than 200 registered Takaful companies

worldwide, operating either through writing Takaful directly or placing it through Islamic windows or marketing agencies. According to the Ernst & Young World Takaful Report 2011 the Takaful market was worth US$12 billion in 2011, an increase of 31% from the US$9.15 billion figure posted the previous year. Regionally, the growth rates between 2010-2011 are shown in Table 1.

Table 1: Takaful Growth Rates, by Region (2010-2011)

Region	Growth Rate Increase (%)
Indian Subcontinent	85
Middle East	40
Gulf Cooperation Council (GCC)	31
Southeast Asia	29
Africa	26

Based on the 2010-2011 statistics, in terms of individual countries Indonesia recorded the largest Takaful market growth rate of 67%, followed by Bangladesh with 58% and Saudi Arabia with 34%.

According to Milliman's Global Family Takaful Report 2010, global Family Takaful gross contributions in 2010 were estimated to be US$1.7 billion: 29% higher than 2009. Between 2007-2010, global Family Takaful gross contributions increased at a compound annual growth rate of 36%. In fact in 2010, Southeast Asia's share of global Family Takaful contributions was 73%, followed by the Middle East with 25% and South Asia with 2%. In short, while most of the General Takaful market is centered in the Middle East and Gulf region, the Family Takaful business is focussed in the Southeast Asia region, especially in Malaysia. Family Takaful in Malaysia was estimated to contribute 77% of net Takaful contributions in the country in 2010.

In Malaysia between 2007-2010, according to a recent Bank Negara Malaysia report, net contributions for Family Takaful increased from RM1.99 billion (US$657.8 million) to RM3.39 billion (US$1.12 billion), an increase of 70.45% or an average growth rate of 17.61%. On the other hand the General Takaful operating profit (including underwriting profit and net investment income) catapulted from RM37.6 million (US$12.4 million) in 2007 to RM202.5 million (US$66.9 million) in 2010.

Challenges

a) Low Penetration Rate

Despite the thriving rate of growth as witnessed in Malaysia and elsewhere in the world over recent times, the level of market penetration compared to that of conventional insurance is still low. Studies on Takaful penetration among Malaysians indicate that better strategies, more awareness of the advantages of Takaful and better understanding of Takaful products may increase the demand for Takaful and these aspects perhaps will consequently improve the Takaful penetration rate among Malaysians.

b) Positioning

Takaful is a knowledge-based product and as a relatively new concept ought to be appropriately positioned and widely promoted so as to create the awareness to the public before products are introduced. The information disseminated thus far through the various channels of the media is neither regular, sufficient nor impactful.

The religious compatibility that is directly linked to Takaful products is dear to the hearts of many Muslims. One of the biggest challenges facing the Takaful market is to fulfil the perception of customers looking for products and systems that are built, operated and serviced in an ethical and fair manner. In this form of niche marketing, Shariah values must be positively used to position Takaful products in facing the Muslim markets. In this instance, are the senior management of Takaful operators truly well-versed in Shariah matters or are they relegating these responsibilities solely to their respective Shariah Committees? To this end, we should be mindful and respectful of the reasons why Takaful was developed initially.

c) Governance

Takaful works on the principles of mutuality. However, many Takaful undertakings are incorporated in the form of a proprietorship. Therefore, this 'hybrid' or 'firm within a firm' dichotomy with a mutual operation within the confinement of a proprietorship corporate set-up may raise a governance issue. The question here is, are the Takaful participants who own the Takaful fund 'protected' or 'represented' in this kind of arrangement? What is the true identity of a Takaful entity: a mutual firm or a proprietorship?

d) Other Challenges

Apart from the challenges mentioned above, there are other challenges that relate to (i) new products; (ii) impact of information technology; (iii) risk management; (iv) re-Takaful; (v) investment issues; (vi) strategic alliances.

Conclusion

As we proceed further into the millennium, Takaful operators will face many more challenges. As the bigger, more efficient conventional insurers expand their market share at the expense of the Takaful operators, Takaful operators must shift their paradigm by constantly reforming and re-engineering their business in order to face the increased competition within and outside the industry.

In order to meet the ever-growing expectation of customers for better quality service, Takaful operators need to increase the awareness of the products by using advanced information technology to their advantage. Finally as a Shariah compliant product, Takaful must to emit to the masses at large its authenticity in order to improve its public perception.

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