Chartered Insurance Institute

590

Advanced Diploma in Insurance

Unit 590 – Principles of Takaful

October 2017 Examination Guide

SPECIAL NOTICES

Candidates entered for the April 2018 examination should study this examination guide carefully in order to prepare themselves for the examination.

Practice in answering the questions is highly desirable and should be considered a critical part of a properly planned programme of examination preparation.

590 – Principles of Takaful

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IMPORTANT GUIDANCE FOR CANDIDATES

Introduction

The purpose of this Examination Guide is to help you understand how examiners seek to assess the knowledge and skill of candidates. You can then use this understanding to help you in your preparation for this examination.

Before the examination

Study the syllabus carefully
This is available online at www.cii.co.uk or from Customer Service. All the questions in the examination are based directly on the syllabus. *You will be tested on the syllabus alone,* so it is vital that you are familiar with it.

There are books specifically produced to support your studies that provide coverage of all the syllabus areas; however, you should be prepared to read around the subject. This is important particularly if you feel that further information is required to fully understand a topic or an alternative viewpoint is sought. The reading list which can be found with the syllabus provides valuable suggestions.

Note the assumed knowledge
For the Advanced Diploma in General Insurance, candidates are assumed to have studied the relevant units of the Diploma in General Insurance or the equivalent. This knowledge is set out on the relevant syllabus.

Read widely
It is vital that your knowledge is widened beyond the scope of one book. *It is quite unrealistic to expect that the study of a single textbook will be sufficient to meet all your requirements.* While books specifically produced to support your studies will provide coverage of all the syllabus areas, you should be prepared to read around the subject. This is important, particularly if you feel that further information is required to fully understand a topic or an alternative viewpoint is sought. The reading list which can be found with the syllabus provides valuable suggestions.

Make full use of the Examination Guide

This Examination Guide contains a full examination paper and model answers. The model answers show the types of responses the examiners are looking for and which would achieve maximum marks. *However, you should note that there are alternative answers to some question parts which would also gain high marks.* For the sake of clarity and brevity not all of these alternative answers are shown.

This guide and previous Examination Guides can be treated as 'mock' examination papers. Attempting them under examination conditions as far as possible, and then comparing your answers to the model ones, should be seen as an essential part of your exam preparation. The examiner's comments on candidates' actual performance in each question provide further valuable guidance. You can purchase copies of the most recent Examination Guides online at www.cii.co.uk. CII members can download free copies of older Examination Guides online at www.cii.co.uk/knowledge.

Know the structure of the examination

Assessment is by means of a three hour written paper.

Part I consists of 8 compulsory questions, worth a total of 48 marks.

Part 2 consists of 1 compulsory question, worth a total of 38 marks.

Part 3 consists of 3 questions selected from 5, worth a total of 114 marks.

Each question part will clearly show the maximum marks which can be earned.

Read the Advanced Diploma in General Insurance information for candidates and important notes for candidates

Details of administrative arrangements and the regulations which form the basis of your examination entry are to be found in the current Advanced Diploma in General Insurance information for candidates and important notes for candidates, which is *essential reading* for all candidates. It is available online at www.cii.co.uk or from Customer Service.

In the examination

The following will help:

Spend your time in accordance with the allocation of marks:

- The marks allocated to each question part are shown on the paper;
- if a question has just two marks allocated, there are likely to be only one or two points for which the examiner is looking for, so a long answer is wasting valuable time.
- Conversely, if a question has 12 marks allocated, a couple of lines will not be an adequate answer. Always remember that if the paper is not completed, your chances of passing will be reduced considerably.
- Do not spend excessive time on any one question; if the time allocation for that question has been used up, leave some space, go on to the next question and return to the incomplete question after you have completed the rest of the paper, if you have time.

Take great care to answer the question that has been set.

- Many candidates leave the examination room confident that they have written a 'good' paper, only to be surprised when they receive a disappointing result. Often, the explanation for this lies in a failure to think carefully about what the examiner requires before putting pen to paper.
- Highlighting key words and phrases is a technique many candidates find useful.
- The model answers provided in this Examination Guide would gain full marks. Alternative answers that cover the same points and therefore answer the question that has been asked would also gain full marks.

Tackling questions

Tackle the questions in whatever order feels most comfortable. Generally, it is better to leave any questions which you find challenging until you have attempted the questions you are confident about. Candidates should avoid mixing question parts, (for example, 1(a)(i) and (ii) followed by 2(b)(ii) followed by 1(e)(i)) as this often leads to candidates unintentionally failing to fully complete the examination paper. This can make the difference between achieving a pass or a narrow fail.

It is vital to label all parts of your answer correctly as many questions have multiple parts to them (for example, question 1(a) may have parts (i), (ii) and (iii)). Failure to fully distinguish between the separate question parts may mean that full credit cannot be awarded. It is also important to note a full answer must be given to each question part and candidates should not include notes such as 'refer to answer given in 1(b)(i)'.

Answer format
Unless the question requires you to produce an answer in a particular format, such as a letter or a report, *you should use 'bullet points' or short paragraphs,* as this allows you to communicate your thoughts in the most effective way in the least time. The model answers indicate what is acceptable for the different types of question.

Where you are asked to perform a calculation it is important to show **all** the steps in your answer. The majority of the marks will be allocated for demonstrating the correct method of calculation.

Provided handwriting is legible, candidates will **not** lose marks if it is 'untidy'. Similarly, marks are not lost due to poor spelling or grammar.

Calculators
If you bring a calculator into the examination room, it must be a silent, battery or solar-powered, **non-programmable** calculator. The use of electronic equipment capable of being programmed to hold alphabetical or numerical data and/or formulae is prohibited. You may use a financial or scientific calculator, provided it meets these requirements. The majority of the marks will be allocated for demonstrating the correct method of calculation.

EXAMINERS' COMMENTS

Question 1
Many candidates were able to explain the difference between physical hazard and moral hazard.

Question 2
Although many candidates defined and explained the concept of *Istihsan*, the application was not sufficiently covered by many.

Question 3
Many candidates were able to explain the concept of *Jahalah* and its prohibition in *Shariah*.

Question 4
Though a direct question, many candidates were not able to identify the objectives of Islamic insurance standardisation.

Question 5
Not many candidates were able to explain the controversy associated with the modified *Mudharabah* model.

Question 6
In general, most candidates were able to explain the concept of MGA and its responsibilities.

Question 7
Though most candidates were able to define *Shariah*, the three objectives of *Shariah* considered necessary for human existence were not explained to in full by many candidates.

Question 8
This question on insurable interest which was answered well by most candidates.

Question 9
Overall candidates performed well on this question relative to the recent examinations however, the answers to part (c) on preparing a response for the senior manager, candidates did not perform as well as expected.

Question 10
Many candidates who attempted this question provided answer covering the overview of the Takaful windows. However, the answers provided by some candidates lacked the depth required for an essay style question.

Question 11
Most candidates provided a satisfactory response to the difference between the proprietary insurance provision model and mutual insurance provision model.

Question 12
Though the answer provided by many candidates covered the overview, the answer lacked the depth expected for a 38 mark question.

Question 13
Most candidates provided a satisfactory answer to this question.

Question 14
Many candidates were able to discuss the opportunities available to the Takaful industry and presented valid arguments to realise its potential and increase its share.

THE CHARTERED INSURANCE INSTITUTE

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Advanced Diploma in Insurance

Unit 590 – Principles of Takaful

October 2017 examination

Instructions

- Three hours are allowed for this paper.
- **Do not begin writing until the invigilator instructs you to.**
- **Read the instructions on page 3 carefully before answering any questions.**
- Provide the information requested on the answer book and form B.
- You are allowed to write on the inside pages of this question paper, but you must **NOT** write your name, candidate number, PIN or any other identification anywhere on this question paper.
- The answer book and this question paper must **both be handed in personally by you** to the invigilator before you leave the examination room. **Failure to comply with this regulation will result in your paper not being marked and you may be prevented from entering this examination in the future.**

Unit 590 – Principles of Takaful

Instructions to candidates

Read the instructions below before answering any questions

- **Three hours** are allowed for this paper which carries a total of 200 marks as follows.

Part I	8 compulsory questions	48 marks
Part II	1 compulsory question	38 marks
Part III	3 questions selected from 5	114 marks

- You should answer **all** questions in Part I, the compulsory question in Part II and three out of the five questions in Part III. The number of marks allocated to each question part is given next to the question and you should spend your time in accordance with that allocation.
- You are advised to spend no more than 45 minutes on Part I.
- Read carefully all questions and information provided before starting to answer. Your answer will be marked strictly in accordance with the question set.
- You may find it helpful in some places to make rough notes in the answer booklet. If you do this, you should cross through these notes before you hand in the booklet.
- It is important to show all steps in a calculation, even if you have used a calculator.
- If you bring a calculator into the examination room, it must be a silent, battery or solar-powered, non-programmable calculator. The use of electronic equipment capable of being programmed to hold alphabetic or numerical data and/or formulae is prohibited. You may use a financial or scientific calculator, provided it meets these requirements.
- Answer each question on a new page and leave six lines blank after each question part.

PART I

Answer ALL questions in Part I
Each question is worth six marks

Note form is acceptable where this conveys all the necessary information

1. Explain briefly the difference between physical hazard and moral hazard. **(6)**

2. Define *Istihsan* and identify **three** reasons for its application. **(6)**

3. Explain briefly the concept of *Jahalah* and its prohibition in *Shariah*. **(6)**

4. Identify **six** objectives of Islamic insurance standardisation. **(6)**

5. Explain briefly the controversy associated with the modified *Mudharabah* model from a *Shariah* perspective. **(6)**

6. Explain briefly what a managing general agent (MGA) is and what its responsibilities are. **(6)**

7. Define *Shariah* and identify **three** objectives of *Shariah* considered necessary for human existence. **(6)**

8. Explain briefly **three** features clarifying the definition of insurable interest. **(6)**

Part II

Compulsory question
This question is worth 38 marks

9. A newly appointed accountant in ABC *Takaful* firm, which uses *Wakalah-Mudharabah* model, has prepared the one income statement for the firm and stated that only one statement is needed to present overall financial performance, as shown below.

Statement of Policyholders' Revenues and Expenses for the year 2016

Revenues	**2016**
Investment income - Shareholders	5,000
Gross investment income for participants	3,000
Wakalah fees	80,000
Mudharib fees	300
Net earned contributions	70,000
Reinsurance commission	45,000
Total Revenues	**203,300**
Expenses	
Net claims	6,000
General expenses	50,000
Acquisition cost	12,000
Development costs amortised	500
Total Expenses	**68,500**
Net Income	**134,800**

After reviewing the statement prepared by the accountant, ABC *Takaful* firm's chief financial officer and the Shariah liaison officer discovered that it was not properly prepared and presented. Using the information shown in the statement above, prepare the following statements covering the year 2016 (*after correcting the accountant's errors*):

(a) Prepare the revised Statement of Policyholders' Revenues and Expenses for the year 2016. **(11)**

(b) Prepare the Income statement for ABC *Takaful* firm for the year 2016. **(7)**

Senior management of ABC Takaful firm have asked you to communicate with the *Shariah* liaison officer and advise them on the following matters:

- The concept of *Qardh-al-Hasan*, its application in a *Takaful* model and how it will be repaid; and
- The profit commission arising from reinsurance and/or re*Takaful* and its application from a *Shariah* perspective.

(c) Prepare a response to senior management on the matters listed above. **(20)**

Part III

Answer THREE of the following FIVE questions
Each question is worth 38 marks

10. Explain the concept of *Takaful* windows and the guidelines provided by scholars to increase their reliability and effectiveness. **(38)**

11. Compare the proprietary insurance provision model and the mutual insurance provision model. **(38)**

12. Explain the core principles for *Muamalaat*. **(38)**

13. Explain the concept of corporate governance and its challenges in a *Takaful* model. **(38)**

14. Explain the opportunities available to the Takaful industry to realise its potential and increase its share. **(38)**

NOTE ON MODEL ANSWERS
The model answers given are those which would achieve maximum marks. However, there are alternative answers to some question parts which would also gain high marks. For the sake of clarity and brevity not all of these alternative answers are shown. An oblique (/) indicates an equally acceptable alternative answer.

Model answer for Question 1

Physical hazard relates to the physical characteristics of the risk and includes any measurable dimension of the risk. For example:

• Security protection at a shop: the greater the security protection, the better the physical hazard level as it may even prevent a loss altogether.

Moral hazard arises from the attitude and behaviour of people. In insurance, this is usually the conduct of the person insured. However, the conduct of the insured's employees and that of society as a whole are also an aspect of moral hazard. Examples include the following:
• Carelessness – a driver's lack of care can increase the chance of an accident happening and its severity.
• Dishonesty – a person who has previously made fraudulent or exaggerated claims represents a poorer moral hazard than one who has not.
• Social attitudes – for example, which do not regard cheating insurers as immoral.

Model answer for Question 2

Istihsan (juristic preference) is a method of exercising personal opinion to give preference to one rule over an existing rule. This is done for the purposes of fairness, public justice and public interest.

Candidates would have gained full marks for any three of the following:
A jurist may resort to Istihsan for the following reasons:
• The existing law is either too general, or too specific and inflexible.
• Its literal enforcement may cause unfairness and be detrimental to many people in certain situations.
• Departure from the existing law is the only way of attaining a fair solution to a problem.
• Another rule offers a means of avoiding hardship and generates a solution that is harmonious with the higher objectives of Shariah.

Model answer for Question 3

Jahalah refers to ignorance or obscurity regarding the object for sale or its price. Jahalah is a consequence or effect of Gharar and its meaning is more specific; everything that contains ignorance is uncertain, but not all things become uncertain due to ignorance. Jahalah occurs when an individual lacks knowledge about the specifics of an object, event or action, despite knowing about its occurrence or existence.

The prohibitions for Gharar given in the Quran and the Sunnah also apply to Jahalah. This is because uncertainty encompasses ignorance. Similarly to Gharar, Shariah only excuses minor Jahalah that does not have the potential to lead to disputes between contracting parties. However, major Jahalah is prohibited and renders contracts of exchange void or defective.

Model answer for Question 4
Candidates would have gained full marks for any six of the following:

1. Harmonise the accounting and financial reporting policies and procedures adopted by Takaful companies.
2. Improve the quality and uniformity of accounting and financial reporting.
3. Promote good ethical practices within the Takaful industry.
4. To improve transparency and disclosure.
5. To establish a robust framework for accountability.
6. Achieve conformity or similarity as much as possible in applications of Shariah rules for investment, financing and insurance and to avoid contradictions and inconsistencies.
7. To ensure financial reporting and accounting meet the Shariah requirements and comply with the principles of Shariah.

Model answer for Question 5

There is a difference of opinion amongst Shariah scholars as to the validity of allowing the TO to share in the underwriting surplus, which in Shariah terms is attributable only to the participants. Some Malaysian Shariah scholars have historically allowed this. However, scholars in the Gulf Cooperation Council (GCC) countries have not always endorsed the acceptance of the model and have encouraged operators to look for other ways to remunerate the TO.

Model answer for Question 6

An insurance company may delegate to another company or partnership its authority to enter into contracts of insurance on its behalf. The recipient of the authority is known as an MGA or, in the Lloyd's market, a cover holder.

Some MGAs not only 'hold the underwriting pen' of the insurer, they also undertake all the other activities of an insurer such as marketing, selling and administration. They do not provide funding for the claims, although they may undertake claims payments from a fund provided by the insurer. An MGA may have full delegated authority or limited authority to underwrite on behalf of its principal. It will usually issue the insurance documentation and will often handle claims.

Model answer for Question 7

Shariah is the legal arm of Islam. It is literally defined as 'path to the watering place' and is technically defined as "Commands, prohibitions, guidance, principles and rules derived from the primary sources of Islam, the Quran and supplementary teachings of the Prophet Muhammad (peace be upon him, PBUH) called the Sunnah".

Candidates would have gained full marks for any three of the following:

Objectives:

- **Faith:** A set of divine rules are given that aim to maintain and protect faith in Allah. They demand faith and obedience and give instructions for seeking the pleasure of God. Faith is the ultimate purpose of Shariah. Without it, all other actions hold no real value to Allah, as there will be no reward in the hereafter.
- **Life:** All life is extremely valuable; above all, the life of a human being. Everyone has a right to life. Shariah prescribes laws regarding means of attaining lawful income, sustenance and shelter. Shariah has severe penalties for murder and other offences which breach the right to life.
- **Property:** Shariah facilitates lawful means of acquiring property and endorses its protection. It prohibits misappropriation and unlawfully usurping another's property. Shariah promotes pro-active planning and safeguarding your property against misfortunes and disasters.
- **Posterity:** Protection of family, children and descendants is one of the fundamental objectives of Shariah. Many of the major prohibitions that carry heavy penalties are in place for the protection of posterity, such as adultery and fornication, and forbid all material that can lead to such actions.
- **Intellect:** Without a sound mind, it is almost impossible to achieve the objectives of Shariah. Intellect is necessary to the existence of the human race. Therefore, Shariah prohibits individuals from carrying out actions that may cause harm to their intellect, such as drinking alcohol. It promotes actions that will improve it, such as the compulsory requirement to attain an education in Islam.

Model answer for Question 8

Candidates would have gained full marks for any three of the following:

Insurable interest
Subject-matter:
• Subject-matter of insurance is the item or event insured. For example, cars and factories, or the potential to be held legally liable for loss or damage to someone else or their property.
• Subject-matter of the contract is the name given to the financial interest the insured has in the subject-matter of insurance. For example, Tom owns a car. The ownership is the financial interest, the subject-matter of the contract.

Legal relationship: The relationship between the insured and the subject-matter of insurance must be recognised in law. For example, ownership is a legal relationship.

Financial value: The insurable interest in the subject-matter of insurance must have a financial value.

Insurer's insurable interest: Insurers have insurable interest in the risks that they have assumed. They reinsure part or all of the risk with other insurers; the subject-matter of the contract being the insurer's financial interest in the original insurance.

Timing of insurable interest: When must insurable interest exist? The answer depends on the class of insurance business. However, the expectation of acquiring an insurable interest in the future is not enough to create insurable interest in general non-marine insurances. For example, Harry will inherit his grandfather's house in the future but does not yet own it so does not have an insurable interest.

Model answer for Question 9

(a) ABC Takaful Firm
Statement of Policyholders Revenues and Expenses

Insurance Revenues	
Net Earned Contributions	70,000
Reinsurance Commission	45,000
Total Insurance Revenue	**115,000**
Insurance Expenses	
Net Claims	6,000
Wakala Fees	80,000
Acquisition Cost	12,000
Total Insurance Expenses	98,000
Net Surplus from Insurance Operations	**17,000**
Investment Income	
Gross Investment Income for Participants	3,000
Less: Mudharib Share	300
Net Investment Income	**2,700**
Surplus of Revenues over Expenses	**19,700**

(b) ABC Takaful Firm
Income Statement

Revenues	
Investment Income	5,000
Wakala Fees (or Income)	80,000
Mudharib Share	300
Total Revenues	**85,300**
Expenses	
General Expenses	50,000
Development Costs Amortised	500
Total Expenses	**50,500**
Net Income	**34,800**

Model answer for Question 9 continues

(c) Qard-al-Hasan

A virtuous or benevolent loan. Loan in the meaning of a virtuous loan that is interest free and extended on goodwill basis, mainly for welfare purposes, the borrower is only required to pay back the borrowed amount.

Regulators in most jurisdictions will require the Takaful operator to provide supplementary capital to underwrite any deficit in the contributors' pool by means of a Qardh-al-Hasan (interest-free loan) and recoup it from future surpluses. The unique arrangement for the Takaful operator to advance Qardh-al-Hasan makes Takaful sustainable and viable, especially in the early years. It also allows Takaful companies to engage in a wider range of businesses than pure risk-sharing mutuals.

Qardh-al-Hasan is repaid from future surpluses as it has a first charge on any future surpluses. In most cases, the effect of having to repay the loan is that participants would be unlikely to receive a share of any future surplus.

Profit commission

A profit commission is a contractual agreement given to the TO by the reinsurer from the reinsurer's investment profit.

An RTO (ReTakaful Operator) would not issue a profit commission. Instead, an RTO would distribute the surplus at the end of the underwriting year in accordance with the reTakaful agreement. However, under a conventional reinsurance programme the TO may be awarded or offered a profit commission based on the reinsurer's profitability under the reinsurance contract, calculated in accordance with the terms and conditions of the contract. The aim of a profit commission is to provide the TO with an incentive to manage the performance of the business that is ceded. A profit commission differs from a distribution of surplus in that the profit commission is a contractual entitlement, rather than a discretionary distribution, and is specific to the performance of a contract.

The TO may accept any surplus distribution from the RTO and deposit the amount into its own PRF. Under Shariah rules, any profit commission received from a conventional reinsurer should not generally be accepted by the TO because the source of the income may be a non-Shariah complaint source.

However, if profit commission is received, then there are two options.

1. Accept the profit commission and then use it to renew the conventional reinsurance policy; or
2. Leave it with the conventional reinsurer and seek a discount from the renewal.

Model answer for Question 10

In many jurisdictions not all Takaful providers are fully fledged Islamic finance institutions. In such cases Shariah-compliant services may be provided by Islamic finance windows of conventional institutions.
These are ring-fenced entities, within the larger financial institution, which operate in compliance with Shariah requirements. In a similar way, a conventional insurance company can provide Takaful by creating a Shariah-compliant window.

A *Takaful* window is defined as, "a department, division, facility, or setup within a conventional insurance entity that provides insurance products and services in compliance with the Islamic principles and rules of finance".

The business, assets and operations of a *Takaful* window are segregated from the operations of the conventional insurance company which established it, and the operation is run as ring-fenced section of the company. In order to provide this segregation, the company may designate separate management personnel to run the window.

An exclusively Shariah-compliant financial organisation (insurance company or bank) is based on foundations that comply with the principles of Shariah. This means the objective of such an institution would be to protect faith, life, intellect, posterity and property. The structure of the institution, ownership, management, objectives and articles or memorandum of association of the institution would be required to comply with the principles and rules of Shariah. The funding, capital, all expenses, all income, all its business activities, all third-party contracts, all business associations – even down to behaviour of its employees whilst carrying out their responsibilities – would have to be in compliance with the principles of Shariah.

In comparison, a *Takaful* window is part of a conventional insurer. The conventional insurer itself is not required to comply with or carry out activities in compliance with the principles of Islamic finance and trade. However, the following must comply:
- all business activities within the window;
- associated third party contracts with the window;
- services provided through the window; and
- all income and expenses of the window.

Benefits of *Takaful* windows
A significant advantage of an Islamic insurance window is that it would continue trading using the brand, rating and resources of its 'host' company – the conventional insurance company. The window may benefit from its host's capital, security, credibility, reputation, authority, management and business relations. In particular, the window may have access to a deeper pool of capital from the host company.

Model answer for Question 10 continues

Criticism of *Takaful* windows

• Commitment – A conventional insurer's incorporation and statutes do not comply with Shariah. For some jurists this raises a question over the insurer's commitment to comply with the Shariah in their *Takaful* windows.
• Supervision – Concern that lack of Islamic expertise or commitment could lead to weak supervision of Islamic windows, resulting in potential violations of Shariah.
• Segregation – Division between conventional operations and the *Takaful* window can be problematic. Concern that the window's funds could be diverted to finance activities of the conventional operation which are not permissible in Shariah.
• Unfair advantage – Concern that conventional financial institutions operating *Takaful* windows could compete unfairly with newly established Islamic financial institutions due to their wealth of experience, expertise and a strong presence in the market.
• Risk of conflict of interest – Concern that a conventional company may prefer transacting through its conventional operations over its *Takaful* window operations.

Strengthening *Takaful* windows

There are a few guidelines provided by scholars to enable the establishment of reliable and effective *Takaful* windows.
• Complete segregation of funds – It is widely held by scholars that, if a window is permitted, there must be a clear segregation between Shariah-compliant funds and the funds of the conventional entity. There should be clear evidence that the segregation is genuine and does exist, such as bank account and computer records.
• Shariah supervisory board (SSB) – The Islamic window should be supervised by an SSB. The window should be managed according to the same principles and standards of corporate and Shariah governance as would be required if it were a standalone Takaful undertaking.
• Managerial commitment – The financial institution's management, which is undertaking the business activities of the window, should be fully committed to it. They should have knowledge of its objectives, principles and prohibitions and ensure the window's activities do not contravene the principles of Shariah. A sign of commitment would be to employ an in-house Shariah scholar to oversee the activities of the Islamic window.
• Safeguarding participants' funds – The contributions in the fund are primarily to pay claims to participants. Management must ensure that the fund is kept pure, that claims are paid on time and unauthorised payments do not enter or leave the fund. If a separate fund is created for investment purposes, management must ensure Shariah rules pertaining to investment are applied.
• Reference to established Shariah standards – *Takaful* windows should comply with established Shariah-based accounting and auditing standards such as AAOIFI and IFSB.

Another possible way to provide window segregation is to 'outsource' the management of the window operation to another party, a managing general agent, in order to provide a more complete segregation of the operation.

Model answer for Question 11

The Proprietary Insurance Provision Model

Proprietary insurance company

A proprietary insurance company is owned by its shareholders. Managers appointed by shareholders run the company. All risks of the operation are borne by the company. Ownership in a proprietary insurance company is transferable. Shareholders can transfer or sell their shares to third parties.

Policyholders' premiums

All premiums become part of the company's funds and claims are managed from these funds. The policyholders have no say in how their premiums are used.

Risk-transfer contract of insurance

The policyholders of a proprietary insurance company have a contract of indemnity in return for the payment of a premium. They expect all valid claims to be paid.

Treatment of surplus or deficits in policyholders' fund

Surplus arising from the operations of the insurance company belongs solely to the company. The policyholders have no share in it except in contracts, which provide for discretionary participation. Conversely, any deficit arising from operations, however incurred, is the sole responsibility of the insurance company. The policyholders have no liability apart from the timely payment of premiums for the provision of the specified insurance cover and a duty to abide by conditions and warranties set out in the contract.

Capital provision and regulatory burden

The company is responsible for meeting all capital and regulatory requirements for the operations. The policyholders have no role in this.

Stakeholder interests

Shareholders of a proprietary insurance operation seek to make a return on the capital that they invest in the company. This forms their key motivation. Policyholders are mainly concerned to ensure that any claims arising can be met in a timely manner. Their only interest in the profitability of the company is to get satisfaction in its ability to meet claims as and when they become due.

Investment of assets

Funds are invested at the company's discretion. The only restrictions on investments are those required by the regulators. These mainly relate to segregation of some funds or investment in sound assets bearing in mind the solvency and liquidity needs to meet any claims in a timely manner.

Model answer for Question 11 continues

Accounting treatment
As policyholder's premiums become part of a proprietary insurance company's funds, only a single set of accounts is prepared to reflect the status of its finances. There is no segregation between policyholders' premium payments and other funds of the company.

Corporate governance
The company is run ultimately for the benefit of its shareholders and their interests provide the main focus for operations. The company must also comply with regulators' and ratings agencies' requirements and ensure adequacy and stability of solvency. Policyholders' interests feature in the operations in as much as they are aligned to shareholders' interests. Thus, competitive pricing and timely payment of claims are key features of proprietary insurance operations.

The mutual insurance provision model

Ownership of a mutual
A risk-sharing mutual is owned by its members and there are no external shareholders. In theory members could manage the mutual. In practice, members appoint professional managers to run the operations on their behalf. However, the appointed managers have no role in the ownership of the mutual. Ownership of a mutual is not transferable. Unlike shareholders in a proprietary insurance company, members can leave a mutual but not transfer or sell their share to another party.

Mutuals' funds
All contributions and income form the contribution pool. The appointed officers of the mutual manage the pool and claims and expenses are settled from it.

Risk-sharing pool and pool indemnity
The contribution pool is a risk-sharing arrangement whereby the company owned by member indemnifies the contributors against the damages arising from specified perils.

Treatment of surpluses or deficits in the contribution pool
In the event of a surplus arising in the contribution pool, members are entitled to share it as they own it. However, due to the on-going nature of the business, in most cases surpluses are added to the reserves of the mutual. Members may see the benefit of robust reserves though lower contribution requirements in the future or through disbursements of discretionary bonuses. Deficits are met from the reserves, by reduction in benefits payable, or in some specialist cases by a call for additional contributions from members. Increasingly, in many cases where a mutual is a company limited by guarantee a call for additional contributions is rarely made. The company normally seeks to supplement its risk pool by raising subordinated debt.

These features make a mutual a risk-sharing arrangement for providing insurance needs. If there are not adequate reserves, mutuals can face the possibility of winding up or being taken over if they are unable to raise the capital to meet their needs. New mutual operations can be challenging to run until adequate reserves have been accumulated. In addition, the need for capital effectively limits the ability of a mutual to write volatile business.

Regulatory burden and capital constraints
The mutual must fulfil all the capital and regulatory requirements needed for its operations. If additional capital is needed, the mutual has to raise it. The managers of the mutual can raise capital from its members or via subordinated debt.

In many jurisdictions there are special regulations for mutuals that reflect their origins and evolution over time. These regulations apply to mutuals already operating. Regulatory requirements for new mutuals are more onerous than in the past meaning that setting up new mutuals or co-operatives can be more challenging.

Key features and contributors' interests
Origin in communal needs of affinity groups – Mutuals usually evolve to serve specific risk-mitigation needs of participants in like-minded communities and geographically proximate areas. This means that their interests are shared in more ways than just the provision of risk-mitigation services. Shared risk mitigation is a consequence of their affinity in other aspects of their lives rather than the sole purpose of a mutual's formation.
Community owned – Mutuals' risk-sharing arrangements mean that deficits in the claims funds have to be made up by participating members or dealt with in other ways such as cutting benefits or raising capital in other forms. This can lead to stress, dissolution or takeover by larger bodies with more capital. The company doing the takeover can be either a mutual or a proprietary insurer. However, because there are now few large mutuals in the UK insurance sector it is more likely to be a proprietary insurance company. This has led to the further shrinking of the mutual sector in the UK.
Long gestation period to sustainability – Like many organisations, mutuals are more vulnerable in the early years of operations before adequate reserves have been built up. Thus most mutuals have a long gestation period to become sustainable. On an ongoing basis, mutuals can also be vulnerable if their product mix changes to incorporate more volatile lines of business or if the regulatory environment becomes more demanding in terms of capital adequacy.

Investment of contributors' pool assets
Contributors' pool assets are managed by the mutual's officers to optimise returns within the regulatory requirements. The management of the assets is primarily geared to providing security for contributors' entitlements.

Accounting treatment
One set of accounts is prepared. The accounts reflect the members' interests. In contrast with Takaful, there is no separation between participants' interests and the operator's interests.

Corporate governance
The operation is managed for the sole interests of the members who are the owners of the mutual, cooperative or friendly society. The risk-sharing features of the mutual provide the key focus for the operations. There are no external shareholders involved, unless the mutual has raised subordinated capital. The constitution of a mutual specifies the rights and obligations of members.
• Members cannot usually interfere directly in the operations, which are the responsibility of the persons appointed to run the mutual.

• Ownership rights of contributors are – in the same way as shareholders of a proprietary company limited to voting on matters specified by the constitution.

Potential tensions can arise around decisions on reserving surplus versus distribution of bonuses from any surplus, or the strategic direction of mutuals (such as trying to grow versus staying small or moving into new types of businesses). In a mutual, the management will want to reserve as much of any surplus as possible to ensure that any future deficits can be adequately provided for. The management may also want to increase reserves to enable new classes of business to be written. For members, these considerations rank in line with their desire to share in any surplus, albeit via reduced contributions for future cover or by direct distribution. Members might not share the management's vision of reserving more than that dictated by prudence. The management of mutuals have to engage in proactive education campaigns to get the members on their side for these decisions. Decisions are resolved by the corporate governance arrangements put in place in the constitution of the mutual. Tensions can become challenging as a mutual gets larger.

Mutuals' share of the insurance market

The mutual model is widespread in many jurisdictions as parts of Europe, Japan and the USA, mutuals and co-operatives account for over a third of all insurance premiums. In the UK their share is much lower.

Model answer for Question 12

To achieve the objectives of Islamic finance, Shariah has prescribed core principles for Muamalaat. These relate to:
- fairness;
- ethical investment;
- transparency;
- participation; and
- tangible assets.

Fairness
One of the main principles of Islamic finance is fairness to contract. Parties to a transaction must be free to agree any terms and conditions as they wish. This is provided that those agreed do not contravene the other core principles of Shariah and are not in conflict with the prohibitions of Shariah. Parties to the contract must then abide by the rules set out in the contract.
For example, parties may agree on how profit is to be shared, its method of delivery, a detailed description of how the agent is to perform and the conditions of remuneration. Contracts are given great importance in the Quran.

Ethical investment
There is a strong link between Shariah and ethical standards. The ultimate objective of Shariah is the wellbeing of mankind and so any ethical standard which conforms to this objective is supported by Shariah, as long as it does not contravene its principles.

Muslims must apply ethical standards to investments. They should review the business they are investing in, taking into account:
- its policies;
- the products it produces;
- the services it provides; and
- its impact on society and the environment.

A Shariah-compliant insurance company must also look carefully at the risk before considering whether to underwrite it. For example, a Takaful company should not provide coverage for a weapons manufacturer or a company that abuses human rights.

Use of capital
In accordance with Shariah principles, capital should not be left idle and should be put to use instead. Islam encourages the investment of capital and profit.

All Islamic financial structures generate some form of return in a manner that is compliant with the rules and principles of Shariah. For example, this may be through rent from a leased property or profit from the sale of goods.

Model answer for Question 12 continues

Transparency
Islam stresses transparency in financial dealings. All Islamic institutions, including Takaful companies, must show transparency in operational practices and financial performances.

Financial transactions must be conducted in such a manner that all the parties are clear about the important facts, including the terms and conditions. A contract will be rendered void if the seller does not fully disclose all material information relating to the product, or the seller intentionally or negligently misrepresents the goods.

In addition to the participant's duty to disclose all material information to the insurer, it is equally important for the insurer to make all material and reliable information available to both clients and shareholders in a timely and accessible manner. Nothing must be hidden; all commissions and fees should be disclosed.

Write and record
It is preferable to write and record all transactions for clarity, certainty and to avoid any future disputes. Should any dispute arise among the contracting parties, a written contract may be used as evidence and can be extremely useful in reaching a resolution.

Participation
In Islamic finance and insurance, risk participation is an important aspect of a financial structure that generates profit and surplus. All parties to an agreement should share in the risk and profit of any endeavour.
To be entitled to a return, a provider of finance must either accept business risk or provide a service, such as supplying an asset. This principle is derived from a saying of the Prophet Mohammed (PBUH) that 'profit comes with liability.' (Sunan Abu Dawood, 24:3502) This means that entitlement to profit only occurs when one bears the liability or risk of loss. By linking profit with the possibility of loss, Islamic law distinguishes lawful profit from all other forms of gain.
In Takaful, participation comes in different forms:
• The policyholders are called the 'participants' because they engage in a participants' risk fund (PRF) towards which they have made a contribution.
• All the participants share the risk via the PRF and it will provide compensation to any participant who suffers a loss.
• The PRF is entitled to any returns generated from investments in its funds.

• The participants are eligible to receive a share of the surplus accumulated at the end of the underwriting year.

Tangible assets
One of the most important characteristics of Islamic financing is that it is asset backed. Financing in Islam is always based on illiquid assets which create real assets and inventories. Profit can only be generated when something with intrinsic value is being exchanged for money. Therefore, all transactions must involve either the use of tangible assets, usufructs or services.

Historically, banks had tangible physical assets in their vaults over which ownership rights were granted in the form of paper money. In consequence, each and every bank note represented an

Model answer for Question 12 continues

underlying asset held in a bank's vaults. However, modern day banking practices do not involve underlying assets.

Existence and ownership
Assets should be in existence before sale. The seller must legally own and have actual possession of the asset before making an offer for its sale. For example, an individual may not insure a house promised to them after the death of their grandfather.

Money is a medium for exchange - from an Islamic perspective, money itself has no intrinsic value and is only a medium of exchange. This means that no charge should be made for its use.

Money is not a commodity and certainly not tradable, unless it is traded in a different currency. It simply acts as the payment mechanism to affect the transfer.
Each unit of money is equal to another unit of the same denomination. Therefore, it is not possible for different parties to generate any profit by exchanging these units with each other (inter se).

Model answer for Question 13

Corporate governance is a defined set of relationships between a company's management, board of directors, shareholders and other stakeholders. It provides the structure through which the:
• objectives of the company are established; and
• means of attaining those objectives and monitoring performance are determined.

In other words, corporate governance is the mechanism by which risks arising are addressed by the company.

In the context of TOs, good corporate governance encompasses:
• a set of arrangements which ensure that the management of the TO aligns, as far as possible, with the interests of its stakeholders;
• incentives encouraging members of, for example, the TO's management, board of directors and SSB to pursue objectives that are in line with the stakeholders' interests and facilitate effective monitoring.
This helps to ensure that resources are used efficiently; and
• compliance with the Shariah rules and principles.

Model answers for question 13 continues

Stakeholders
Stakeholders can be defined as individuals with a vested interest in the wellbeing of a TO. For example, they include its:
• employees;
• participants;
• suppliers;
• community; and
• regulators and governments.

All enterprises have different stakeholders with different interests. The challenge to the corporate governance system is how to ensure that the interests of the different stakeholders are addressed within the ethical framework of the Takaful company.

Conflicts of interest
As the Takaful model has evolved, it has taken on a for-profit hybrid role which is split between the risk-sharing pool and the commercially motivated TO. Such duality can mean that the interests of the participants and the operator in a Takaful company are not always aligned and conflict of interests can arise. These are compounded by the fact that the Takaful operation generally takes the form of a single legal entity, internally divided into segments attributable to the interests of the participants or shareholders. A distinction is drawn between the Takaful company as a whole and the TO as the management that must align the different interests. The TO is the active organiser of the operation and is responsible for meeting the regulatory obligations.
As in conventional insurance, Takaful operations need to have processes in place for identifying any conflicting interests of different stakeholders and for managing those conflicts in a fair manner. In addition, as in all matters of ethics, the board of directors will be expected to seek the SSB's advice on fulfilling any particular requirements of Shariah-compliant management of stakeholder interests.

Fees and profit sharing
In some Takaful operating models, the TO may share in the underwriting surplus through a profit sharing arrangement, often as a 'performance fee'.
Setting the fees to be received by the TO, the rate of profit sharing in Mudharabah arrangements and determining the level of management expenses to be reimbursed from the claims fund are also areas of conflicts in interest. For example, the cost of the obligation of providing Qardh-al-Hasan if the participants' fund suffers from a deficit is not explicitly priced into the Wakalah or Mudharabah contract.
As a result, it is likely to be recouped in non-transparent ways such as implicitly pricing it into the Wakalah fees or the Mudharabah profit-sharing rate.

The remuneration of the TO by a fee may also lead to incentives to indulge in behaviours to maximize revenue rather than to manage risk to the fund. For example, deliberate pricing below prudent levels to gain market share or maximise Wakalah fees.

Model answer for Question 13 continues

Many Shariah scholars remain opposed to profit sharing and this issue continues to create controversy in Takaful companies. The industry, led by the Islamic Financial Services Board (IFSB), is coming to the view that these issues can only be overcome if the participants' pool itself achieves **capital adequacy**. This means a higher proportion of the surplus would be reserved and not distributed.

Treatment of surplus

The treatment of surplus is a particular area of potential conflict, as decisions must be made about how it will be used where this is not prescribed. If the contract provides for the distribution of surplus, participants may have distribution expectations which conflict with the TO's wish to retain more. The TO may want to reserve much more of the surplus than that which is required by regulation or recommended by the company's actuaries as provision against future contingencies. This could be for a variety of reasons and may include the following considerations:

• To mitigate the obligation to inject Qardh-al-Hasan in the event of a deficit in the future, by reserving more than the minimum required.

• The TO's strategy may include plans for expansion or the need for a particular credit rating for the business, which may require retaining more than the amount prudently indicated by the actuaries.

• The TO may be expected to have a more long-term view of the business than the participants and set its risk appetite accordingly.

Qardh-al-Hasan

It is clearly noted that the requirement for the TO to provide Qardh-al-Hasan in the event of a deficit has become a distinguishing feature of Takaful. It is normally an implied condition of licensing by Takaful regulators and can serve to align the interests of the participants with those of the TO by encouraging the TO's prudent behaviour.

However, where the participants' pool is persistently unable to repay Qardh-al-Hasan, this can impose a burden on the Takaful company and have adverse consequences for the industry.

ReTakaful

Certain aspects of reTakaful – such as claims recoveries (as any proceeds claimed as recoveries from the RTO should be credited to the PRF), reTakaful commissions (as any ceding commission received by the TO, the TO must return the commission to the PRF) and profit shares – have the potential to create conflicts of interest between the participants and the TO.

In order to avoid such conflicts, these processes must be handled transparently.

Model answer for Question 14

Conventional market
Takaful providers may take business from established insurance operators. For example, this may happen where Shariah scholars insist that assets financed by Islamic banks need to be insured using Takaful. The global financial crisis also helped the Takaful market to compete more effectively with conventional insurance companies. However, it is important to remember that Takaful companies looking to tap into such opportunities need to make sure they provide appropriate and cost-effective cover.

Global financial crisis
The global insurance market has experienced a mixed growth trend over the last decade with a marked downturn during the financial crisis. The market has since recovered to a certain extent, but growth rates remain subdued.
In contrast, the impact of the financial crisis on the Takaful sector has been much less significant. As available statistical data demonstrates that Takaful gross premiums continued to grow throughout this period at a higher rate than those of conventional insurance. This is despite Iran's sanctions regime which hampered the country's growth rates in 2013–14.

The Takaful sector was able to escape the worst effects of the financial crisis partly because of its small size; the sector accounts for less than 3% of the global insurance industry. In addition, the key Takaful markets, such as Malaysia, were not affected by the crisis to the same degree as those where Takaful is less prevalent, for example, across Europe. These factors have helped Takaful to compete more effectively with conventional insurance companies.

Takaful market
It is noted that the Takaful sector's share of the insurance industry is lagging behind those of other Islamic finance assets. This suggests that there is a lot of potential growth which can be achieved by better servicing the Islamic finance market. In marketing terms, this market can be referred to as 'low hanging fruit' which is ready to be plucked.

Emerging market economies
The demand for insurance is projected to rise at a faster pace in **emerging market economies** than in the markets of developed countries. There is a well established connection between GDP per person and insurance penetration; a report published by the Islamic Financial Services Board (IFSB) in 2016 shows that insurance demand strongly increases as economies move through a typical transitional phase of development.
This phase of development is currently being experienced by major potential Takaful markets, such as Indonesia and South Asia. Insurance penetration levels were previously very low in these counties, as demonstrated by the available statistical data.

Insurance penetration rates are likely to grow at a rapid pace as these countries experience economic growth. This will present the Takaful sector with the following opportunities:

• **Urbanisation of societies –** Malaysia, for example, has changed from being 70% rural in the 1970s to nearly 70% urban in 2015, and similar trends are evident in other societies. This means that the traditional 'self-insurance' possibilities provided by extended family and tribal groups may

Model answer for Question 14 continues

no longer be possible, as people in cities often have to make their own risk mitigation arrangements.

• **Increase in GDP –** Economic growth leads to an increase in personal wealth and creates more need for the insurance of corporate assets, liabilities and interests, such as business interruption.

• **Fewer State-sponsored welfare benefits –** With the protracted period of historically low oil and commodity prices, such benefits are expected to come under pressure in many countries. This would cause a greater need and scope for the private provision of many services which are traditionally provided by insurance companies.
An increase in insurance potential does not necessarily mean growth in Takaful. The key question for the Takaful industry is how much of this potential growth will be captured by them rather than conventional insurers.

Other opportunities
Developments in technology are expected to provide cost-effective connections between insurers and customers. This may encourage the inclusion of the poorest communities in the financial system, for example, by giving greater scope to micro-Takaful provision. This provides an alternative to conventional micro-insurance provision, where insurance services are tailored to the needs of low-income households and offered in return for premiums that are proportionate to the risks covered. The World Bank is pursuing micro-insurance and micro-Takaful projects, and the IFSB has issued a standard on micro- Takaful.

Iran presents an opportunity for Takaful provision. As the country's sanctions are lifted, its insurance industry is projected to resume its growth. Iran also has significant untapped potential for family Takaful provision.