Chartered Insurance Institute

590

Advanced Diploma in Insurance

Unit 590 – Principles of Takaful

October 2019 Examination Guide

SPECIAL NOTICES

Candidates entered for the April 2020 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. 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 obtain copies of the two most recent examination guides free of charge at www.cii.co.uk.

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

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.

EXAMINER COMMENTS

Candidates overall performance

In general candidates' overall performance was good however more detailed answers and in-depth knowledge of concepts were required for candidates to achieve high marks, in particular in section three.

Reference to previous question papers will assist candidates in understanding the expectations of essay style questions contained within the latter parts of this paper.

Question 1
This question required candidates to explain the effect of developments in technology on *micro-Takaful* provision. Many candidates scored well but some struggled with its requirements.

Question 2
This question examined candidates ability to explain *Waqf* (trust fund) arrangement and its application in *Takaful*.

Question 3
This question tested candidates ability to identify responsibilities of a *Takaful* operator.

Question 4
This question tasked candidates with explaining the *Takaful* insurance provision important adaptations to the conventional insurance models and the adaptations results with candidates scoring well.

Question 5
The question tested the risk-return participation in Islamic finance and insurance and identify different forms of participation in *Takaful* and candidates did not score well.

Question 6
This question required candidates to identify risks arising from segregation of funds and was generally answered well.

Question 7
A question where candidates were expected to outline the limitations of alternative assets to *Takaful* funds. Only a few candidates provided the required depth and have consequently received high marks for this question.

Question 8
Candidates were required to demonstrate the Saudi Arabian regulator's approach to *Takaful* and candidates struggled with this question.

Question 9
Many candidates scored well in this question asking candidates to prepare the statement of policyholders' revenues and expenses and part (b) asking for a comparator.

Question 10
This question required the application of core principles of Islamic Finance, some candidates provided the depth and sufficient detail that is required for an essay question.

Question 11
This question tasked candidates with discussing *Takaful* windows and was generally answered well.

Question 12
Candidates were asked to explain *Riba* and *Jahalah* and their prohibition in *Shariah* and was not answered to a good standard.

Question 13
Candidates were posed with the question of describing the mutual insurance provision model and scored well.

Question 14
This question asked candidates to explain the function of risk management in insurance and was well answered.

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Advanced Diploma in Insurance

Unit 590 – Principles of Takaful

October 2019 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 effect of developments in technology on *micro-Takaful* provision. **(6)**

2. Explain briefly a *Waqf* (trust fund) arrangement and its application in *Takaful*. **(6)**

3. Identify **six** responsibilities of a *Takaful* operator. **(6)**

4. Describe briefly the *Takaful* insurance provision important adaptations to the conventional insurance models and the adaptations results. **(6)**

5. Explain briefly risk-return participation in Islamic finance and insurance and identify different forms of participation in *Takaful.* **(6)**

6. State **three** risks arising from segregation of funds. **(6)**

7. Outline the limitations of alternative assets to *Takaful* funds. **(6)**

8. Explain briefly the Saudi Arabian regulator's approach to *Takaful.* **(6)**

Part II

Compulsory question
This question is worth 38 marks

9. As the Chief Financial Officer of ABC *Takaful* firm, which uses the Wakala-Mudharaba model, your accountant has collected the quantitative data and reported it to you as shown in the table below.

Statement of Policyholders' Revenues and Expenses for the year 2018.

Account	**(£)**
Reinsurance Commission Income	48,000
Mudharib share	600
Contribution receivable	1,800,000
Reinsurer's share of contributions	156,000
Retakaful payables	2,400,000
Acquisition cost	18,000
Increase in outstanding claims	12,000
Other liabilities	3,600,000
Development costs amortised	480
Increase in unearned contributions	48,000
Shareholders' investment income	12,000
Paid claims	192,000
Surplus carried forward from previous year	60,000
Gross contributions	360,000
Wakala fee	72,000
Participants' investment income	6,000
Recovered claims from reinsurers	132,000
General expenses	72,000
Surplus distribution to policyholders	28,800
Purchase of fixed assets	120,000
Takaful payables	12,000,000

After reviewing the quantitative data presented in the table on page 6, the Board of Directors has requested you to prepare the Statement of Policyholders' Revenues and Expenses for the year 201

(a) Prepare the Statement of Policyholders' Revenues and Expenses for the year 2018. **(19)**

The Board is also considering investing in and/or acquiring *Takaful* firms in Malaysia and Middle East countries. They have requested you to provide a comparison between the asset composition of *Takaful* contribution pools between the key markets of Malaysia and Middle East countries.

(b) Prepare the comparison for the Board of Directors. **(19)**

Part III

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

10. Explain the limitations and challenges facing *Takaful* as a developing industry and how *Takaful* companies are dealing with such limitations and challenges. **(38)**

11. Discuss the *Takaful* windows. **(38)**

12. Explain *Riba* and *Jahalah* and their prohibition in *Shariah*. **(38)**

13. Describe the mutual insurance provision model. **(38)**

14. Explain the function of risk management in insurance. **(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

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.

Model answer for Question 2

Waqf is designed for the purpose of creating a trust fund. The owner of this particular trust fund is God alone. Waqf is a religious charity and everything owned by this charity is 'as if it were owned by God'. The proceeds in the fund exist to benefit the wider community.

The application of Waqf in Takaful is as follows:
• TO establishes a Waqf fund through initial donations;
• the TO cannot own the fund, so appoints itself as the Wakil of the Waqf fund instead. Thereafter, it is entitled to remuneration (agency fees);
• participants pay Tabarru towards the Waqf fund and become members; and
• participants are entitled to compensation when required on the basis that they are beneficiaries and not in consideration of their donations.

In a separate contract, the TO may also take the role of Mudharib while the Waqf fund acts as Rab al Maal. Investment profits are shared between the TO and the Waqf fund. If any surplus arises from the operations of the Waqf fund, this remains in the ownership of the Waqf fund.

Model answer for Question 3

- obtaining the operating licence and regulatory approvals;
- provision of adequate capital to meet regulatory requirements and maintain solvency;
- establishment of effective governance processes;
- controls to protect the interests of the participants;
- controls to secure compliance with Shariah and relevant regulations;
- designing and marketing the products;
- managing the assets and liabilities; and
- administering the business.

Model answer for Question 4

Takaful insurance provision involves two important adaptations to the conventional insurance models.

• The first key change is designed to remove or mitigate identified Shariah objections to conventional modes of insurance provision in:
– the insurance contract itself; and
– the mode of operation of the insurance company.

- The second is to devise a commercially viable and sustainable model of mutual provision for an industry in its infancy.

As a result, Takaful has developed methods of segregation between:
• a contributors' (or participants') risk-sharing pool; and
• a commercially motivated Takaful operator managing the pool for a fee.
The operation of the resulting entity is supervised by the Shariah supervisory board (SSB).

The approach may involve segregation into separate legal entities; however, the predominant model involves internal segregation within a single legal entity.

Model answer for Question 5

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.

Model answer for Question 6

The segregation of Takaful funds into PRF, PIF and shareholders' fund brings a set of risks that are unique to Takaful, including:
• risk of incorrect attribution of transactions to a fund;
• risk of the PRF requiring financial support from shareholders' fund due to inability to meet its solvency and/or liquidity needs;
• risk of shareholders' fund having to provide an interest-free loan (Qardh-al- Hasan);

• risk of the loan not being repaid and resulting in the loss of capital for the shareholders' fund; and
• risk that fees and investments profits transferred from the PRF to the shareholders' fund are inadequate to meet the expenses of the TO in carrying out its obligations and commitments stipulated in the contract.

Model answer for Question 7

Increasingly private equity and commodity funds have become highly geared tools so are not suitable for Takaful funds. Conventional insurers make extensive use of derivatives to manage investment risk.

For Islamic investment managers, investment in private equity funds, commodity funds and some derivatives is possible subject to the limitations on gearing mentioned above. Many derivatives and hedging instruments remain outside the Shariah-permissible framework. Takaful companies have found it difficult to meet their desired level of exposure to this asset class.

Model answer for Question 8

Having encouraged the growth of Takaful throughout the past two decades, the regulators in Saudi Arabia have pulled back this approach since around 2013. They no longer authorise any new Takaful companies and require existing Takaful providers to convert to the regulators' own version of a cooperative model of insurance provision.

The Saudi co-operative model is not like the more familiar co-operative insurance provision model. Instead, it contains a larger element of risk transfer. This means that any losses caused are to be borne by the operators rather than the participants. The operators also benefit from any gains, with a discretionary 10% distribution to participants in good years. Part of the rationale behind these changes is the operators' previous accumulation of Qardh-al-Hasan (interest-free loan) liabilities. They did not have concrete plans for the recoupment of these liabilities and so placed a significant amount of strain on the stability of the country's Takaful providers.

Model answer for Question 9

(a)

Insurance Revenues	
Gross Contributions	360,000
Less: Reinsurer's share of contributions	156,000
Net retained contributions	204,000
Less: Changes (Increase) in unearned contributions	48,000
Reinsurance commissions income	48,000
Total insurance revenue	**204,000**
Insurance Expenses	
Paid claims	192,000
Recovered claims from reinsurers	132,000
Net paid claims	60,000
Changes (increase) in outstanding claims	12,000
Wakala Fee	72,000
Acquisition cost	18,000
Total Insurance Expenses	**162,000**
Net surplus from insurance operations	**42,000**
Investment Income	
Participants' investment income	6,000
Less: Mudharib Fee	600
Net Investment Income	5,400
Surplus of revenues over expenses	**47,400**

(b)

There are significant variations in the asset composition of Takaful contribution pools between the key markets of Malaysia and Middle East countries.

Malaysian TOs have been able to deploy their assets in a manner more closely approaching that of the typical insurance industry investment manager than the typical Takaful company. The Malaysian asset allocation is predominantly cash followed by the fixed income class/category. The Malaysian asset class allocation is primarily due to the availability of short-dated Islamic debt securities and longer-term Sukuk facilitated by the Malaysian government. The risk: return profile of Sukuk provides an adequate replacement to Malaysian Takaful companies for bonds available to their conventional counterparts and provides a form of debt security.

In contrast to Malaysia, the investment profile for Takaful companies in the Middle East and North Africa (MENA) is not so similar to that of conventional insurers. The MENA asset class allocation is predominantly cash and real estate. Part of the difference in the asset mix in the Malaysian and MENA markets can be attributed to their underlying contrast in insurance portfolios.

Malaysian TOs derive the majority of their contributions from family (life) Takaful products. In contrast, Middle Eastern Takaful portfolios are weighted towards the general market. As a result, Malaysian life operators can take a longer view and are likely to hold a larger portion of fixed income/Sukuk assets to match their long-term liabilities compared to their MENA counterparts.

In addition, the market weighting is compounded by the relatively undeveloped fixed-income markets in the Middle East. The issue of undeveloped fixed-income markets is more acute within Islamic finance. Sukuk securities are heavily concentrated in Malaysia with only a small amount available in the Middle East, the vast majority of which are domiciled in Saudi Arabia. Thus, Takaful investment managers in the Middle East will continue to face greater challenges in managing their portfolios than their counterparts in Malaysia. Sukuk lacks the deep and liquid markets that exist for some fixed-interest securities and this limited access to guaranteed returns hampers efficient portfolio management. However, sovereign Sukuk issuances in the other parts of the Gulf Cooperation Council (GCC) countries of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates are increasing and the gap between supply and demand is expected to narrow over time.

Model answer for Question 10

Availability of appropriate reTakaful
ReTakaful fulfils a similar function to reinsurance in conventional operations and is key to increasing the capacity to accept risk. Several reTakaful companies have launched in recent years. Many of them are relatively young and deal with a limited class of business. Some such as Hanover Re (Bahrain), Munich Re (Malaysia) and Swiss Re (Malaysia) are owned by global reinsurance companies and can service a larger class of business. However, the scale and sophistication of reTakaful companies is still lagging behind the growth of the Takaful industry; it is not only the availability of reTakaful capacity that matters, but the availability of sufficiently diversified capacity of high quality. As a result many Takaful companies cede business to conventional reinsurance companies when appropriate reTakaful is not available.

The use of conventional reinsurance is an area of concern for Shariah scholars and has an impact on the credibility of Takaful in its target markets. Shariah scholars have encouraged the use of reTakaful rather than reinsurance. However, they also recognise the limitations of the present reTakaful provision and have allowed Takaful companies to use reinsurance providers under the principle of 'necessity' (Dharurah) until appropriate reTakaful capacity becomes available. ReTakaful and reinsurance is frequently placed on a subscription basis, raising the possibility of gradual increase of the share of one cover that is placed on a Shariah-compliant basis. The IIFA and IFSB recommend that reTakaful availability and specific Dharurah permission is reviewed regularly.

Reinsurance is an international business with hubs in several key jurisdictions, including London and Bermuda, where risks are placed on a syndicated basis. Recent developments in the provision of Shariah-compliant capacity by conventional insurers operating in the London Market offer scope for greater Shariah-compliant capacity in this market over time. This has the potential to increase the share of Takaful contributions ceded to RTOs rather than conventional reinsurance providers.

Shortage of skills, knowledge and experience
Shortage of soft skills is impeding the growth of the Takaful industry. Surveys reported in Finance Forward World Takaful Report 2016 (Middle East Global Advisors) assessed the industry's perception of the kind of skills and knowledge needed for the industry. The results show that whilst technical skills tend to be more readily available, key managerial skills are harder to come by.

Product development and marketing skills are also in short supply. This is critical in a competitive industry where Takaful is competing with conventional insurance provision. If Takaful is to capture a large share of the projected growth in insurance requirements, these shortages will become more critical. The Islamic finance industry as a whole suffers from a shortage of suitably qualified Shariah scholars knowledgeable in Islamic commercial law and contemporary financial practices. This is even more so in the Takaful industry where Shariah scholars familiar with insurance operations are far fewer. The skill shortage impedes the development of perspectives and products which comply with the Shariah requirements but at the same time reflect insurance industry norms.

Linkage with international standards and practices

International co-operation among professional bodies and regulators has led to the development of global standards setting minimum requirements for many businesses. In the insurance industry, the standards of the International Association of Insurance Supervisors (IAIS) are relevant and the IFSB has sought to develop guidance for supervisors on how to reflect the characteristics of Takaful in relation to these standards. In addition, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has also developed Shariah standards, though different understandings and practices of Shariah in member countries have impeded standardisation. In many countries in which Takaful companies operate the use of International Financial Reporting Standards (IFRS) is mandatory.

The relevant standard for insurance is IFRS-4 Insurance Contracts. IFRS-4 requires insurance operations – including Takaful – to be treated as one reporting entity. Thus, the AAOIFI requirement for separate reporting of the interests of the participants' pool from those of the TO can be challenging to implement.

In practice, a Takaful operation generally takes the form of a single legal entity, internally divided into segments that are attributable to the participants' interests on the one hand and the shareholders' interests on the other. Segmental reporting within a single legal entity provides a potential resolution to the Shariah requirement for separation of participants' and shareholders' interests in a Takaful operation. This may also provide a way to implement IFRS-4 for Takaful accounting which is in keeping with Shariah requirements. The International Accounting Standards Board (IASB) – which issues the IFRS – and AAOIFI have formed a liaison committee to explore these issues and some agreed treatment is expected to emerge in the future.

Rating agency treatment

As the Takaful industry matures, it will need more companies with high credit ratings to inspire confidence in its clients. An issuer credit rating (ICR) is a credit rating agency's independent opinion of an entity's ability to meet its ongoing financial obligations. In general, reTakaful/Takaful operators which are part of bigger insurance and reinsurance groups tend to attract a high rating.

The key challenge rating agencies face is to determine the exact status of the relationship between the participants' pool and the TO. The rights and obligations of each party are sometimes ambiguous and lack of clarity in the legal relationships can create confusion in determining the strength of the TO. Two key considerations are whether Qardh-al-Hasan is mandatory and whether it is subordinated. If either is not the case, and surplus has not been accumulated in the fund, then financial strength ratings will suffer.

As Takaful companies mature and further precedents are established for the treatment of the different categories of assets, rating agencies have been able to establish more robust criteria for evaluations of these companies. Also as suggested earlier, if Takaful companies build more robust reserves beyond those required by capital adequacy or prudential concerns, the participants' pools themselves will achieve their own standalone capital adequacy. Such a scenario will attract much better ratings from the agencies. This will, in turn, attract a larger client base to use Takaful.

Solvency II implications for Takaful operations
Solvency II is a European regulatory regime for determining capital adequacy for insurance operations.
Though not directly applicable to the Takaful markets in Asia and the Middle East, Solvency II will apply to any Takaful operations that are established in the EU and to EU groups into which Takaful operations are consolidated. A key feature of concern for Takaful companies will be the separation of Takaful pools (participants' contribution pools) from the TO's funds and resources. Under Solvency II such separation would constitute 'ring-fenced funds', for which capital requirements are calculated separately but may be covered by central funds, though surplus within a ring-fenced fund cannot cover capital adequacy requirements elsewhere in the company. If the Takaful company fails to build up surplus in the pool to meet capital adequacy, the burden of capital adequacy will fall entirely on the TO. Therefore, Solvency II provides an incentive for separately maintaining the capital adequacy of the Takaful pool as well. There is an argument to be made that instead of focussing on short-term surplus distribution, Takaful companies should be using any 'surpluses' primarily to build the capital adequacy of the participants' pool itself. Again, this is a relatively new area for Takaful and is expected to evolve as the industry grows. The IFSB has issued guidance and standards on the solvency requirements of Takaful companies including IFSB-11 Standard on Solvency Requirements for Takaful (Islamic Insurance) Undertakings, December 2010.

Different interpretations of Shariah requirements
Different interpretations of relevant Shariah requirements have emerged as the Islamic finance industry has developed. Some of these variations have resulted from the presence of different jurisprudential schools of thought amongst Muslims. Others have been a result of the positions of leading jurists.
Surplus – For the Takaful industry there have been different positions on the allocation of any part of the surplus to the TO. There have also been variations on the centrality, or otherwise, of surplus distribution itself.
Islamic debt market – In investment management, the development of the key short-term Islamic debt market is also subject to Shariah interpretations. Thus, the adoption of this market has been possible in
Malaysia but not in the GCC countries.
Standardisation – Due to the varying Shariah interpretations, standardised regulations and cross-border alliances have also become more challenging. The IFSB has issued a number of standards and guidance notes for the Takaful industry. These have the potential to provide a building block for some key standardisation of treatment of Takaful operations on a global scale. Any such development will greatly aid the further development of the industry.

Focus on agency-based distribution
Efficient and cost-effective distribution is increasingly becoming a key requirement of good profitability in the insurance industry. In many countries in which Takaful is provided, the primary distribution channel is the historical agency-based model. This is costly and needs to be adapted.
Newer channels like bancaTakaful and online distribution using social media can be much more cost effective. BancaTakaful is the Islamic equivalent to the conventional bancassurance, an arrangement in which insurers sell their products through an established banking network. Malaysia has adopted bancaTakaful for its family Takaful and has seen good growth. However, the GCC lags behind newer distribution innovations. This is impacting on the profitability of the industry in relation to its conventional counterpart.

Low levels of family Takaful
In many countries, Takaful providers are still focussed on general lines of insurance. This is a more volatile class of business and needs to be balanced by provision of family Takaful, which is slower to build but grows steadily over the long term. Again, Malaysia has made more strides in the provision of family Takaful than operators in the GCC countries. This presents a challenge and an opportunity for the Takaful industry.

Takaful and risk transfer
There has been a perception that surplus distribution is a key feature of a risk-sharing Takaful model. However, in practice, any surplus can be put to much better use for the growth of the business. Thus, attaining capital adequacy for the participants' fund, attaining better rating for the business or creating the right capital mix for the expansion of the business all depend on having robust reserving arrangements. Any surplus distribution should be the last resort in most cases.
If a reconsideration on surplus distribution and the adoption of more robust reserving policies does not happen, challenging scenarios can result. For example, consider the case of a series of cumulative deficits in the participants' pool funded by a Qardh-al-Hasan from the TO with no definitive resolution of the deficit in sight. This is not a situation which any regulator will encourage. Some industry observers argue that if the current reserving regime persists, it will lead to consolidation in the sector with stronger and well capitalised companies absorbing the weaker ones. In Saudi Arabia, the regulator has mandated the industry to move towards a 'co-operative' model. The Saudi model is not a co-operative as understood in the insurance industry; rather, it entails a shift towards risk transfer, with no requirement for any deficits to be borne by the participants. The TO is required to fund any deficits but is allowed to distribute up to 10% of any surplus to the participants.
It is becoming evident that a fundamental shift in the role of surplus sharing is urgently required to preserve the risk-sharing features of Takaful provision.

Model answer for Question 11

<u>Takaful windows</u>
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.

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 12

Riba (usury)

Riba (usury) can be defined as:
“An increase in one good for another in an exchange, without any form of consideration for the increase”.
Source: Kanzul Daqaiq fi Fiqh al Hanafi by Imam abi Barakat Abd Allah bin Ahmad al Nasafi

Shariah regards all forms of interest as Riba and impermissible. This prohibition is prominent because interest plays a central role in modern banking, economics and finance.

Prohibition
Riba is probably the most well known prohibition in Islamic finance; it is mentioned several times in the Quran, where it is equated to particularly damning acts, and is also reported by many companions of the Prophet Muhammad (PBUH) in the Sunnah. For example, the Quran includes the following text:

Those who devour Usury will not stand except as one whom has been driven to madness by the touch of the Evil One (Satan). That is because they say: ‘Surely trade is like Usury’ but Allah has permitted trade and forbidden Usury. (Quran, 2:275)

O you who believe, Fear Allah and give up what remains of your demand for interest, if you are indeed believers. If you do not (give up usury), then take notice of war from Allah and his Apostle. (Quran, 2:278–9)

A Hadith is narrated by Abu Huraira (MABPWH) in which the Prophet Muhammad (PBUH) includes the devouring of interest as one of the seven grave sins. (Muslim, 1:161) In another Hadith, the Prophet (PBUH) condemns the one who takes Riba, the one who pays it, the one who writes the agreement for it and the witnesses to the agreement. (Nasai, 48:5107)

Explanation
There are many types of interest and there have been various attempts to encompass these under one definition. It is sufficient for us to understand that in a contract of exchange where goods are passed from one individual to another, something equivalent in value or service must be exchanged in consideration or as compensation; nothing more or nothing less.

Ibn ‘Arabi states ‘all excess over that justified by consideration’ is interest. Any excess exchanged is construed as interest because the increase does not represent any value. Benefitting and allowing others to benefit from this excess are also forbidden. Example 3.11 demonstrates a transaction in which Riba is present.

In contrast to Gharar and perhaps Maysir, the prohibition on Riba is not necessarily a matter of the insurance transaction but instead relates to the operations of the insurer. Riba in an operation of an insurer can arise in several ways.

One of the key ways is the investment of the insurer’s reserve funds to earn a return until claims actually materialise. The funds are invested in a range of asset classes including cash, bonds, equities, real estate and alternative assets. All these asset classes have features which may violate the requirements of Shariah. For example, a common feature of insurance assets is that a large proportion of the funds are invested in interest-bearing bonds; interest is considered Riba, so the investments become impermissible. Investment managers have devised investment strategies that avoid Riba. These make it possible to overcome this particular Shariah objection to conventional modes of insurance provision.

Jahalah (ignorance)
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.

Prohibition
The prohibitions for Gharar given in the Quran and the Sunnah also apply to Jahalah. This is because uncertainty encompasses ignorance.

The word 'uncertainty' is not explicitly mentioned in the Quran. However, the activities described in the following verses are believed to be uncertain:
O ye who believe! Eat not up your property among yourselves in vanities: But let there be amongst you Traffic and trade by mutual good-will: Nor kill (or destroy) yourselves: for verily Allah hath been to you Most Merciful! (Quran, 4:29)

And their charging of interest, although indeed they have been forbidden from it, and their devouring of peoples' properties falsely, and We have prepared for the disbelieving amongst them, a painful chastisement. (Quran, 4:161)

Commentators have agreed that the word 'falsely', used in the latter verse, implies gross uncertainty. Furthermore, there is a Hadith narrated by Abu Huraira (may Allah be pleased with him, MABPWH) in which he states, 'Muhammad (PBUH) has forbidden sales that contain uncertainty'. (Muslim, 10:3614)

Explanation
Jahalah occurs when an individual lacks knowledge about the specifics of an object, event or action, despite knowing about its occurrence or existence.

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, such as that shown in example 3.12, void or defective.

Model answer for Question 13

The mutual model provides an alternative way to manage risk. In this model, members share the risk among themselves rather than transfer it to a third party or company. It is not uncommon for large mutual insurers also to write insurance contracts on a non-mutual basis. Only the mutual policyholders have ownership rights.

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 members 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 per the global mutual market share 2014, in 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 14

Risk identification
This step involves the company discovering its possible existing and potential future threats. Not all of these risks will be insurable, but they all must be managed. For example, in the case of a retail shop, petty theft and shoplifting may be real risks and will need to be managed in some way or funding set aside to cover their costs.
For many conventional risks, an insurer may become involved in helping identify existing and potential risks through carrying out a physical examination or survey. Insurers also play a role in relation to risk control when they provide reports following the survey. Even if the risk is not ultimately insured, the client still has the benefit of the insurer's advice concerning the risk.

Risk analysis
Risk managers examine past data to evaluate or analyse the risk. For example, they can look at the past loss pattern of, for example, hurricanes on the east coast of the USA, and so predict likely losses in the future.
Insurers will look at many of the same elements when considering the rating of a risk.

Risk control or risk mitigation
If the risk is seen to have the potential for adverse consequences, some course of action should be put in place to control, reduce or even eliminate the risk. Elimination is the most effective but may be costly or impractical.
For example, if a manufacturer carries out some paint spraying, then this has the following risks (not an exhaustive list):
• Spraying other items because the area has not been sealed and the paint has moved in the wind, perhaps onto other people's property.
• Employees becoming ill because they have breathed in paint vapours. The manufacturer has the choice not to perform the process altogether and in so doing eliminate that element of the risk.

Alternatively, they can analyse, assess and manage the risk to prevent or minimise the occurrence of any adverse consequences. Part of that analysis will be cost-based, e.g. how much does it cost to enclose entirely the spraying area to prevent over-spray. Does it make more practical sense to have the spraying done by another organisation?
The final part of the analysis is whether it makes financial sense to keep the process on site and purchase some insurance in the event of damage to other people's property or employees through this process being performed. The elimination of risk, or even its reduction, will always be subject to the test of whether the cost of doing so is reasonable compared to the cost of the feared event happening.

Insurers assist in the area of loss prevention and control. They do so by imposing requirements and making recommendations designed to improve the risk, following the completion of a survey. The recommendations are an important part of the pre-risk surveyor's report and are aimed at either improving the risk to an acceptable standard from the insurer's point of view or offer premium reduction as an incentive for worthwhile risk improvements.
In a wider context, insurers are involved in researching areas of loss prevention and control.
Insurers must strive constantly to ensure that their knowledge of their potential clients' businesses remains up-to-date, whether that is in relation to new types of building construction, the further development of offshore drilling technology or changes to the law that extend potential liabilities.

Risk transfer

As mentioned earlier, risk transfer is the final stage of the risk-management process. It is a control strategy by which an insurable risk is contractually shifted from one party to the other. Purchasing an insurance policy in exchange of a premium is one such example of risk transfer, in which the specified risk of loss is transferred from the policyholder to the insurer.

Risk sharing

There are forms of insurance that do not require the transfer of the entire risk. Instead, risk sharing is preferred. The process of managing risks through risk sharing operates by spreading the risk amongst several participants or through syndication. The premiums from the participants are collected in a fund from which the participant is compensated if they suffer any loss. An example of participation is mutuals; syndication is effectively used in Lloyd's of London when one single large risk is shared amongst several Lloyd’s syndicates.