Chartered Insurance Institute

590

Advanced Diploma in Insurance

Unit 590 – Principles of Takaful

October 2020 Examination Guide

SPECIAL NOTICES

Candidates entered for the June 2021 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.

When studying for the 590 *Takaful* examination, it is recommended that candidate's study past Examination Guides and read the Examiner's Comments in preparation for sitting this examination. In doing so this should aid candidates in identifying areas of the syllabus which require further study.

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
Candidates scored well on this question tasking them with describing components of risk.

Question 2
This question on *Shariah* objection to conventional insurance provision and important adaptations within *Takaful* insurance provision compared to conventional insurance models was answered well by most candidates.

Question 3
Explaining the primary and secondary sources of *Shariah* was done relatively well by candidates.

Question 4
This question on how *Riba* can arise in the operation of an insurer saw mixed responses.

Question 5
Identification of the various types of risks that the *Takaful* operator and the *Takaful* fund are exposed to was generally answered well.

Question 6
Explaining the purpose of AAOIFI FAS 13 and the specific disclosures relating to how the surplus is determined and distributed saw poor overall candidate performance.

Question 7
Candidates were asked to outline three issues that arise in a *reTakaful* context that require special attention from a *Shariah* perspective.

Question 8
Discussion of the opportunities that *Takaful* sector can take advantage of to grow in the emerging market economies saw varied responses.

Question 9
It seemed like many candidates were prepared for a numerical question as was the case with the previous couple of years' papers and perhaps this is the reason why not many scored well relative to previous sittings in this question.

Question 10
This comparison question on the principal modes of insurance provision was answered relatively well.

Question 11
Candidates struggled with this question.

Question 12
This question tasking candidates with discussing the additional objectives and the core principles prescribed by *Shariah* to achieve these objectives, saw mixed responses.

Question 13
This question proved to be popular and candidates generally did better in these types of questions.

Question 14
Candidates did better in the essay style questions in this October 2020 sitting. Moreover, this question proved a popular selection alongside question 13. It asked candidates to explain what a *Takaful* fund is, the importance of segregation of funds, and a discussion of the types of funds and their purpose.

Chartered Insurance Institute

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Advanced Diploma in Insurance

Unit 590 – Principles of Takaful

October 2020 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. Describe briefly the various components of risk. **(6)**

2. Explain briefly the *Shariah* objection to conventional insurance provision, and **two** important adaptations within *Takaful* insurance provision compared to conventional insurance models. **(6)**

3. Explain the primary and secondary sources of *Shariah*. **(6)**

4. *Shariah* regards all forms of interest as *Riba*, the prohibition of which is not necessarily a matter of the insurance transaction but can relate to the operation of the insurer.

Explain how *Riba* can arise in the operation of an insurer. **(6)**

5. Identify the various types of risks that the *Takaful* operator and the *Takaful* fund are exposed to. **(6)**

6. Explain the purpose of AAOIFI FAS 13 and the specific disclosures relating to how the surplus is determined and distributed. **(6)**

7. Outline **three** issues that arise in a *reTakaful* context that require special attention from a *Shariah* perspective. **(6)**

8. Discuss the opportunities that *Takaful* sector can take advantage of to grow in the emerging market economies. **(6)**

Part II

Compulsory question
This question is worth 38 marks

9. ABC *Takaful* Company, an established *Takaful* operator in Malaysia, is planning to expand their operations to the Middle East. The ABC *Takaful* Company believes in having a prudent approach to their asset-liability management by creating a balance between liquidity, return and risk for which having access to all the asset classes of investment is vital to achieve the appropriate balance.

You are the Investment Manager of ABC *Takaful* Company. Upon direction of the Board, the Investment Committee of ABC *Takaful* Company has asked you to prepare a comprehensive report on the following:

(a) The available investment classes and their limitations, if any, from a *Shariah* perspective. **(23)**

(b) Availability of Islamic debt securities and Sukuk. **(5)**

(c) Variations in the asset class composition of *Takaful* contributions between Malaysia and Middle East countries. **(10)**

Part III

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

10. Compare the principal modes of insurance provision. **(38)**

11. Explain the role of *Takaful* operators in initiating and managing the *Tabarru* and their remuneration structure, explaining the role that *Takaful* operators play in maintaining the solvency of the *Takaful* operation and their obligations and responsibilities in the management of deficit and treatment of surplus. **(38)**

12. The *Shariah* branch, *Muamalaat* has additional objectives of its own.

Discuss these additional objectives and the core principles prescribed by *Shariah* to achieve these objectives. **(38)**

13. Explain the basic *Wakalah* model, the modified *Wakalah* model and how the *Wakalah* model is adapted for family *Takaful* business. **(38)**

14. Explain what a *Takaful* fund is, the importance of segregation of funds, discuss the types of funds and their purpose. **(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

The various components of risk are:

(i) Uncertainty – Uncertainty, which is at the very core of the concept of risk, implies doubt about the future, as a result of incomplete knowledge. As there is no prior knowledge of an event taking or not taking place, we can say that we live in an uncertain or risky environment and that risks exist separately from the individual.
(ii) Level of risk – Risks are usually assessed in terms of frequency and severity which are the measurement criteria used in the risk-management process.
(iii) Perils and hazard – A peril can be defined as that which gives rise to loss. A hazard can be defined as that which influences the operation of effect of the peril.

Model answer for Question 2

The main basis for the *Shariah* objection to conventional provision is due to the presence of the following elements that may compromise the *Shariah* objectives of fairness and justice. The contract must not include elements such as:

- Gharar (uncertainty)
- Maysir (speculation) and
- Riba (usury)

Takaful is an alternative to the conventional concept of insurance that is based on the *Shariah* concepts of mutuality and cooperation. *Takaful* insurance provision is based on two important adaptations to the conventional insurance models:

- The first key change is to remove or mitigate identified *Shariah* objections to conventional insurance provisions in the insurance contract itself and the mode of operation of the insurance company; and
- The second is to devise a commercially viable and sustainable model of mutual provision.

Model answer for Question 3

The two primary sources of *Shariah* are

- The Quran – Muslims regard the Quran as the foremost sources for Islamic knowledge and guidance.
- The Sunnah – The Sunnah refers to the traditions of the Prophet Muhammad (PUBH) and includes his authentic sayings, reported actions, tacit approvals and physical attributes.

Candidates would have scored full marks for any four of the following:
Shariah has the following secondary sources

- Ijma (consensus) – Ijma refers to the consolidated opinions of all the *Shariah* jurists. The opinions must have been formulated from at least one of the primary sources and must not contradict either the Quran or Hadith.

- Qiyas (analogical deduction) – It refers to the application of an original rule, which was established through the sources of *Shariah* on an earlier case, to a current issue for which no relevant *Shariah* rule exists.
- Ijtihad (legal reasoning) – It is the exertion of maximum intellectual effort in order to find a conclusion to a matter related to the *Shariah*. It is an important source of Islamic law.
- 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.
- Urf (custom) – recurring practices which are acceptable to people of sound nature.

Model answer for Question 4

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

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.

Model answer for Question 5

Candidates would have scored full marks for any six of the following:
The risks that the *Takaful* Operator and the *Takaful* fund are exposed to are:
- Operational risk – risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.
- Underwriting risk – risk of loss due to underwriting activities related to the PRF.
- Market risk – risk of losses arising from movements in market prices.
- Credit risk – risk that a counterparty fails to meet its obligations in accordance with the agreed terms.
- Liquidity risk – risk of loss to the *Takaful* fund arising from its inability to meets its obligations (including claims) in a timely manner
- Legal, compliance and *Shariah* non-compliance risk – a risk relating to the *Shariah*-compliance, legal and regulatory implications arising from the *Takaful* funds insurance activities.
- Risk arising from segregation of funds – the segregation of *Takaful* funds into PRF, PIF and Shareholders' funds brings a set of risks that are unique to *Takaful* business.

Model answer for Question 6

The purpose of FAS 13 is to regulate the disclosure of the bases for determining and allocating surplus or deficit in Islamic insurance companies in order to present reliable and relevant information to assist users of financial statements in their decision making process. FAS 13 focuses primarily on the relationship between the participants and the shareholders and the resulting transactions that occur due to the relationship.

FAS 13 requires the following disclosures:

1. The basis that governs the relationship between the participants and shareholders in respect of the management of the insurance activities and investment.
2. On what basis was the remuneration determined for the above services and any variations that occurred to the determination during the year.
3. On what basis the investment profit was generated from the funds allocated.
4. The basis for investment of funds in income-producing investments and the priority applied in the event the investor was unable to invest all the available fund for these investments.
5. The method of distribution of surplus and *Shariah* principles and rules applied to that particular method.

Model answer for Question 7

Candidates would have scored full marks for any three of the following:
The issues that arise in specific context of re*Takaful* that require attention from a *Shariah* perspective are:

1. **Recoveries claimed** - If the TO becomes eligible to recover from the RTO, then any proceeds claimed as recoveries from the RTO should be credited to the PRF because:
    - the claims were paid out from the PRF;
    - the purpose of re*Takaful* was to assist with claims and strengthen the PRF; and
    - there is a potential conflict of interest: if the recoveries are not paid into the PRF, it could be viewed as a covert stratagem to divert the contributions from the PRF into other accounts.
2. **Ceding Commission** - Under *Shariah* rules and AAOIFI *Shariah* Standard 41, it is not permissible for the TO to receive ceding commission. When TOs seek reinsurance or re*Takaful* solutions, they must ensure that they are quoted net contributions as opposed to gross contributions. Gross contributions include the ceding commission which is then returned to the TO. If the ceding commission is received by the TO, then the TO must return the commission to the PRF.
3. **Profit Commission** - 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. However, if profit commission is received, then the TO may use it to renew the conventional reinsurance policy or leave it with the conventional reinsurer and seek a discount from the renewal.
4. **Interest receivable** - There is the potential presence of interest/usury in other aspects of reinsurance contracts entered into. As long as the TO or the RTO ensures that all investments are *Shariah* compliant, then they will not be in receipt of any interest. However, if the operators were to receive any interest, then this must be isolated and donated to charity as a purification process.

Model answer for Question 8

The economic growth and the consequent insurance penetration will present the *Takaful* sector with the following opportunities to grow.

- **Urbanization 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 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.

Model answer for Question 9

(a) Major asset classes available to the investment managers of *Takaful* companies include:
• cash;
• short-term debt and money market instruments;
• bonds (Sukuk) (sovereign, corporate);
• equity (shares and real estate investment trusts); and
• alternative assets (private equity, hedge funds, loans, derivatives, real estate).

Cash
Holding cash does not present any *Shariah* challenges to the Islamic investment manager; however, just holding cash does not produce any returns.

Short-term debt and money market instruments
Instead of holding cash, insurance companies often hold short-term debt and money market instruments which are traded on the stock exchanges. Money market instruments are short term, low risk, fixed-income financial securities with a relatively high degree of safety because their issuers have the highest credit ratings. These generally account for a significant proportion of an insurance company's asset portfolio.

However, *Takaful* companies find it difficult to source such securities as they tend to be interest-bearing in nature.

Bonds
Bonds offer relatively stable returns and are generally considered to be lower risk than shares, though they often have lower returns as well. Insurers often use both Sovereign bonds and Corporate bonds.

Bonds and debt securities present a major challenge to the Islamic investment manager. This is because their interest bearing nature renders them ineligible for *Shariah*-compliant investment pools. However, in the last few decades Islamic financial institutions and several governments have started to issue Sukuks. These produce bond-type returns and are *Shariah* compliant.

Equity
Investment in equities are seldom regarded as being more profitable over the long term than investment in bonds. However, listed equity prices are cyclical and losses may occur if there is a need to sell the shares in a market downturn. As a result, insurance companies tend to keep a low proportion of their funds in equities to capture the long-term returns produced.

In a similar manner to ethical investors, the equities that *Shariah*-compliant *Takaful* companies may invest in reflect their underlying beliefs and ethics. For example, *Takaful* companies should not invest in forbidden industries such as gambling and interest-based financial institutions, or highly geared companies.

Real estate
Investments in real estate (property) generate returns as a result of rental income and capital appreciation, although they are exposed to capital depreciation during downturns. However, such investments offer insurance companies limited liquidity when they need to sell/release funds.

A *Takaful* investment manager can use real estate assets which are *Shariah* compliant to meet any required exposure to this asset class.

Alternative assets
This asset class comprises of high-risk and high-return investments and consist of investments in private equity funds, commodity funds, hedge funds, derivatives and real estate (property).

For Islamic investment managers, investment in private equity funds, commodity funds and some derivatives are possibly subject to the limitations on gearing. 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.

(b)
The requirement for *Shariah* compliance in investment of *Takaful* contribution pools places some restrictions on Islamic investment managers. The key challenge is to have sufficient access to Islamic debt securities and the bond class.

Short-term debt securities and bonds of various tenure and maturity profiles provide insurance companies with 'near' cash while offering some return over holding cash. These are typically interest-bearing securities and thus unavailable to the *Takaful* company.

Shariah-compliant money market instruments and Sukuk, which provide bond-type returns have been developed over the last decade. These developments have provided *Takaful* investment managers with adequate asset classes to invest their liquidity. However, the supply of these instruments is still much less than the demand for them.

A typical *Takaful* company holds much more cash to compensate for the dearth of Islamic debt securities and bond-type instruments.

(c)
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 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. 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. Sukuk securities are heavily concentrated in Malaysia with only a small amount available in the Middle East. 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 are increasing and the gap between supply and demand is expected to narrow over time.

Model answer for Question 10

The key features of insurance provision by proprietary, mutuals/co-operatives and *Takaful* insurers can be summarised in the table below:

Feature	Proprietary	Mutual/Co-operative	*Takaful*
Ownership	- Shareholders - Transferable	- Members - No external shareholders - Non-transferable	- Members - No external shareholders - Non-transferable
Payment and funds	- Premiums. - Part of company's funds. - Policyholder's have no share or say in use. - Claims met from company's funds.	- Contributions - Contribution pool - Claims met from pool	- Tabarru contribution - Contribution pool - Claims met from pool
Contract basis	- Risk transfer - Bilateral in nature - Indemnity in return for payment of premium	- Risk sharing - Bilateral in nature - Indemnity as part of membership	- Risk sharing - *Shariah* compliant *Takaful* operator contract - Unilateral in nature - Indemnity as part of membership
Treatment of surplus or deficit	- Surplus belongs to company - Surplus likely to be paid as no-claim bonuses to policyholders and dividends to shareholders - No policyholder liability - Deficits met from Company's funds	- Members entitles to share of surplus - Surplus likely to be retained in pool - Member liability - Deficits met from reserves - If reserves are insufficient, deficit funded by subordinated debt - In a few cases, members may be	- Members entitles to share of surplus - Surplus encouraged to be retained in the pool - Members liability - Deficits met from reserves. - If reserves are insufficient, deficit funded by *Qard al Hassan.*

		required to make additional contributions to meet deficits	
Capital provision and regulation	- Company is responsible - Capital contribution	- Member-appointed managers are responsible - New mutual: same capital requirements as proprietary insurance - Existing mutual: less burdensome capital requirements - Capital may be raised via subordinated debt.	- *Takaful* operator is responsible. - Same capital requirements as proprietary insurance - Capital provided by *Takaful* operator - Pool encouraged to build its own capital base.
Stakeholders' motivation	- Return on investment for shareholders	- Risk mitigation for members - Origin in communal needs	- *Shariah*-compliant risk mitigation for participants. - Return on investment for *Takaful* operator. - Origin in communal needs.
Investment of assets	- At company's discretion - Adhere to regulatory requirements of capital, solvency and liquidity	- At manager's discretion as agreed by members. - Optimize returns to provide security for contributor entitlements. - Adhere to regulatory requirements of capital, solvency and liquidity.	- *Shariah*-compliant investments. - Optimise returns within the ambit of *Shariah* - Adhere to regulatory requirements of capital, solvency and liquidity.
Accounting	- Single set of accounts - No segregation of policyholders' premium and company's other funds	- Single set of accounts. - No segregation of contributors'' and operator's interests.	- Segregated accounts for *Takaful* operator and participant.
Corporate governance	- Managed in interests of shareholders. - Managers appointed by shareholders	- Managed in interests of members. - Managers appointed by members	- Managed in interests of participants. - Members appoint *Takaful* operator, who appoints managers.

Model answer for Question 11

In a typical *Takaful* model, the risk-sharing contribution pool is made up of Tabarru (donations) that is initiated and managed by a *Takaful* operator (TO). In all cases this includes investment of funds such as:

- participants' pool;
- participants' risk fund (PRF);
- participants' investment fund (PIF); and
- claims fund.

The TO is remunerated for the management of the pool by an arrangement in the form of a:

- Mudharabah (risk-sharing partnership) contract;
- Wakalah (agency) contract; or
- Waqf (endowment) fee.

The TO plays a critical role in maintaining the solvency of the *Takaful* operation.

Management of deficit and obligation to provide *Qardh-al-Hasan*

The obligation of the TO provide *Qardh-al-Hasan* (benevolent, interest-free loan) in the event of a deficit in the claims fund is a key distinguishing feature of *Takaful*. In most cases:

- *Shariah* scholars have endorsed the idea of the TO injecting Qardh-al-Hasan in the event of a deficit; and
- it is a mandatory requirement by regulators in most jurisdictions where *Takaful* insurance is provided.

Insurance business periodically requires large amounts of capital. The mechanism of Qardh-al-Hasan enables the capital to be provided by an operator who does not, under *Shariah*, assume the risk which is shared by the participants. Thus the funds are loaned as needed.

The obligation to inject Qardh-al-Hasan also acts as a disciplining role on the
activities of the TO. The obligation to fund deficits provides the TO with an incentive to manage the contributors' fund prudently in order to avoid the need for the loan. Some of the factors that can lead to a deficit in a claims fund could be:

1. An unusual occurrence of insurable events can lead to larger than actuarially anticipated or projected claims.
2. Non-payment of outstanding contributions or recoveries (bad debts).
3. Bad management of *Takaful* operations, ranging from expense ratios to claims handling and collection of outstanding contributions.
4. Deliberate pricing below prudent levels; for example, to gain market share or maximise Wakalah fees.
5. Bad investment management can lead to lower returns from asset management compared to those achieved by competitors.
5. Poor re*Takaful* (reinsurance) arrangements can lead to inadequate and costly risk management.

The obligation to inject Qardh-al-Hasan is also onerous for the TO and can create conflicts of interest.

Treatment of surplus
Takaful companies handle a surplus in a number of ways. The first call will be to ensure that the relevant capital adequacy requirements are met by reserving an appropriate portion. The next priority will be the settlement of any outstanding Qardh-al-Hasan provided by the TO. After this an appropriate amount will be set aside for reserves to meet future contingencies.

Before the distribution of surplus back to participants, it is prudent that a number of considerations are taken into account; only then should any excess surplus be released. These include:

- carrying surplus forward to provide better working capital for the fund;
- reduction of future contributions by applying no-claims and loyalty bonuses; and
- funding charitable purposes.

Where the terms of contracts provide for distribution of some portion of excess surplus, this is usually done in one of three ways:

Distribution of the surplus to all participants – Under this method all participants are entitled to a proportion of the surplus regardless of whether they made a claim during the period or not. The surplus will be shared proportionately based on the contribution paid to the pool.

Distribution of the surplus only to participants with no claims – This method only allows surplus to be allocated to participants who did not make any claim during the period under consideration. The logic behind this method is similar to that used in a no-claims bonus scheme in conventional insurance. A proportional basis is used but only amongst the participants who have made no claims in the period under consideration.

Distribution of surplus to all participants based on the net result of each participant – This method mixes the rationale of the two previous methods. It allows all participants to share in the surplus proportionately, based on the net underwriting result of each participant (contributions–claims.

In all cases, the disposition of any surplus should be in line with the provisions in the product/policy contract.

Model answer for Question 12

The *Shariah* branch, Muamalaat (business relations), has additional objectives of its own which conclusively lead to the higher objective of *Shariah*. These objectives only apply to business activities, i.e. trade and finance are:

- economic and social fairness and justice;
- equitable distribution of wealth; and
- the middle path.

Economic and social fairness and justice
Islam encourages trade and business activities to be carried out for the purpose of creating a healthy and vibrant society in which people can be happy and flourish despite their inherent differences. Some people are stronger, healthier and richer than others. However, *Shariah* seeks to set a level economic and social playing field, in which those who are at a disadvantage do not get exploited, and the rich and powerful do not impose their supremacy unfairly. *Shariah* attempts to extinguish any opportunity for abuse of power and position which may cause imbalances in society. Islam forbids the exploitation of unhealthy human instincts and making money through immoral and injurious products. It ensures reward for those who deserve it and that loss is shared by all

participants. Islam rejects any dealing that establishes an unwarranted enrichment without a justified effort.

Equitable distribution of wealth
Shariah disapproves of the concentration of wealth in the hands of the few. A common feature of economic societies that are interest based is that the majority of the capital is possessed by very few wealthy individuals. Their lending and borrowing system is influenced and motivated by interest rates, which result in the 'rich getting richer and poor getting poorer'. The lender's objective usually is to make more money through the use of money, without any effort or work on their part. If the loan is not repaid, the lender has the option to repossess the borrower's assets and recover the initial loan, plus any payable interest and charges for defaulting repayments. The borrower, whose business venture did not go as planned, becomes poorer as a result.

Shariah forbids making money out of money. If an individual lends money to a friend, then all that is due back is the amount that was loaned and not a penny more. The lender cannot generate a return through a loan, but must put their capital at some sort of risk.

The capital owner is encouraged to invest their wealth instead. This means they have a vested interest in the business venture, as they are entitled to any profits generated and must also bear the burden of any resulting losses. The business owner, who is less wealthy, shares the profit with the capital provider as agreed and does not have to bear any losses alone.

The middle path
Shariah strives to achieve a balanced and tolerable society. It restricts human behaviour from becoming too extreme either through application or due to a complete lack of activity.

Islam accepts the benefits of certain activities, such as trade, but also has restrictions in place to ensure that they are not used as tools for manipulating and bringing harm to others. For example, Islam adopts the middle path with regards to capitalism; it recognises the benefits that capitalism brings in its aim to reward individual enterprises but limits its influence where it threatens society's collective interests.

<u>Core Principles</u>
To achieve the three objectives mentioned above, *Shariah* has prescribed the following core principles for Muamalaat.

- **Fairness** – parties to a transaction must be free to agree any terms and conditions as they wish provided that they do not contravene the other core principles of *Shariah* and are not in conflict with the prohibitions of *Shariah*.
- **Ethical investment** - 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. Ethical standards must be applied to all investments.
- **Transparency** - 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

- **Participation** - 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.
- **Tangible assets** - Islamic financing is asset backed. 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.

Model answer for Question 13

The Basic Wakalah Model

The Wakalah model is based on the Wakalah (agency) fees contract where the TO receives an upfront fee or commission from every participant that signs up. The commission is paid from the contribution pool to the TO for managing the operation. The TO does not receive any other remuneration. Therefore, the key financial driver for the TO in the Wakalah model is the number of participants.

Like the other arrangements, any surplus is attributable solely to the participants. In a similar way to the Mudharabah models, the TO normally has a regulatory or commercial obligation to fund any deficit in the claims pool by injecting Qardh-al-Hasan. The funds of the contribution pool and the funds of the TO are segregated.

Incentive risk and conflict of interest – The pure Wakalah contract does not incentivise the TO to maximise investment returns or underwriting efficiency as it has little to gain from it. The TO needs only to avoid the claims fund falling below the prescribed level of regulatory capital and triggering the obligation to inject Qardh-al-Hasan. Perversely, because the more contributions are received the bigger the Wakalah fee will be, there is a risk of an incentive to accept bad business purely to get the upfront fee. There may even be a motivation to under-price products in order to gain market share; by the time any Qardh-al-Hasan obligation is triggered the damage would have been done.

Commercially challenging – The Wakalah model has also proven commercially challenging to operate. There is a tendency to charge high Wakalah fees in order to award adequate remuneration for the TO. However, this can impair the quality of the whole operation by potentially compromising its capital adequacy. This issue is specifically addressed in the modified Wakalah model.

The Modified Wakalah Model

In order to appropriately incentivise the TO, a modified Wakalah model has also been used. The modified model allows the TO to benefit from a **performance fee** in addition to the Wakalah fee for sourcing the contribution. The performance fee is paid as a pre-agreed ratio from any underwriting surplus.

Controversy – Some *Shariah* scholars object to any sharing of the surplus with the TO and so have reservations about granting a performance fee from the surplus.

The TO's obligation to tide over any deficit by injection of a Qardh-al-Hasan loan remains the same as in all other models.

Family *Takaful*: Wakalah Model

There are two overall categories of *Takaful* provision: General *Takaful* and **Family *Takaful***. The difference between the general insurance Wakalah model and the Family *Takaful* Wakalah model is the division of the contribution pool.

Similarly to premiums in conventional life insurance contracts, contributions to Family *Takaful* arrangements normally include an investment element in addition to provision of pure risk mitigation. TOs divide the contribution pool into:

- **participants' risk fund** (**PRF**); and
- **participants' investment account** (**PIA**).

Apart from the division of the contribution pool into a PRF and PIA, the family model works in the same way as a Wakalah arrangement for general insurance.

Model answer for Question 14

***Takaful* fund**

In theory and in essence, the *Takaful* fund is a pool of contributions that the participants create to help each other. However there are some questions *Takaful* practitioners have debated in relation to the *Takaful* fund such as:

- what is the structure and form of this fund?
- should the *Takaful* fund be a company with legal rights?
- should the fund be the ownership of another legal entity?

Formation of the *Takaful* fund:

<u>**In theory**</u>
An independent *Takaful* fund – some scholars and insurance practitioners have argued that the *Takaful* fund should be independent from both the participants and the operators who manage the fund either by

1. granting it its own legal status; or
2. establishing a completely segregated account for the fund which has no connection with the operator's account.

The first of these is unlikely to be possible, which leaves the second as the main model.

***Takaful* fund owned by the participants –** IFSB have expressed that the *Takaful* fund should be attributable to the participants. However, the participants' liability as owners should be limited to outstanding claims and deficits in the fund.

<u>**In practice**</u>
In practice, the two theoretical positions described pose challenges and complications. In reality, the participants do not:

- arrange to have a *Takaful* arrangement;
- establish a fund; or
- appoint an operator.

Instead, it is the TO that:

- creates the *Takaful* product;
- makes arrangements for a *Takaful* fund;
- markets the product; and
- invites participants to subscribe.

Segregation of funds

For purposes of achieving clarity and certainty, the distribution of contributions received from the participants are deposited into separate accounts or funds. The separate funds are classified and defined with titles so that they are immediately identifiable.

The classification of funds will allow the TO to establish and observe an important principle in *Takaful*: the **segregation of funds**.

Segregation of funds will allow:

- the operator to identify the purpose of each fund;
- the *Shariah* scholars to apply the relevant *Shariah* rules to each fund;
- the auditor to carry out effective auditing;
- transparency and disclosure;
- to keep the contributions in each fund pure from contamination; and
- to keep funds pooled only with those risks specified in the contract.

Once the contributions have been received, they are deposited into segregated and appropriate funds as below:

- shareholders' fund;
- participants' risk fund (PRF);
- participants' investment fund (PIF); and
- other funds.

Shareholders' fund

The TO's Wakalah or Mudharabah fees, depending on what model is adopted, are placed in a **shareholders' fund** or a TO's expense fund – sometimes directly from the participants' contributions and sometimes transferred from the participants' risk fund.

The shareholders' fund also holds the following assets:

- paid-up capital and reserves attributable to shareholders;
- profit on the investment of capital and shareholders' reserves;
- such proportion of the investment profit generated by the investment of the policyholders' fund and technical and other reserves as is attributable to them; and
- performance fee (if agreed).

The administrative expenses of the investment department are deducted from the shareholders' fund according to the contract i.e., depending on whether or not the shareholders bear specific expenses in exchange for a Mudharabah fee.

Participants' risk fund (PRF)

The remaining contribution received from the participants is transferred into the PRF, also known as the policyholders' fund. The assets of the PRF consist of:

- contributions received;
- recoveries received from reinsurers;
- the proportion of the investment profits attributable to participants as agreed by contract; and
- consultancy and other receipts.

All the claims payable to the participants shall be met out of the PRF. The contract specifies which other expenses are borne out of the PRF and which borne by the operator; for example: reinsurance costs, technical reserves, administrative expenses and fees that relate to insurance activities, loss adjuster's fees and so on.

Participants' investment fund (PIF)
Many *Takaful* companies – especially those that provide coverage for homogenous risks, such as family (life) *Takaful* – divide the PRF into two distinctive funds:

- one fund to manage claims; and
- one fund other solely for investment purposes.

Any investment profit gained would be deposited into the investment account and all investment losses would be borne by this **participants' investment fund** (**PIF**).

Other funds
Some TOs will segregate family *Takaful* business into two funds:

- ***Takaful* protection fund**; and
- ***Takaful* annuity fund**.

Some *Takaful* companies also segregate the surplus into a surplus fund or a *Takaful* reserve fund.