TRUST . TRANSPARENCY . INDEPENDENCE

# Takaful Methodology

الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency
*Serving the Islamic Ummah*

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# TAKAFUL
# METHODOLOGY

## Preamble

Shari'a (Islamic Laws) may be termed as a rule of law, which fundamentally covers all practical and spiritual (aspects of a Muslim's life. The Holy Quran advocates the concept of muslim brotherhood, whereby muslims, while nurturing piety and charity, are encouraged to share and/or to mitigate the sufferings of the unfortunate ones amongst them. Also, the Sunnah (teachings and customs) of the Prophet (peace be upon him) validate the philosophy of protection and caution). This rationale is strengthened from a Hadith – 'Tie the camel first then put your trust in Allah'.

The word risk for the purpose of conventional insurance, is generally described as uncertainty regarding occurrence of an economic (financial) loss. The uncertainty (al-gharar) factor inherent in a conventional insurance cover obtained and possible element of al-maiser, have been termed by Muslim Scholars and Jurists as inconsistent with the tenets of Islam.

Over the years, insurance had evolved on the "risk-sharing" concept (based on mutuality) and later transformed into a "risk-transferring" mechanism (particularly after introduction of stock companies formed to transact insurance business, from 1920 onwards) replacing the element of "uncertainty" with "certainty". Specifically, conventional insurance takes away the element of individual risk via transfer to a common risk-group of an insurance company against payment of a fair consideration (premium). However, if instead of transferring mechanism, insurance is transacted by pooling of resources to help those in need i.e. mutual-sharing (depicting the virtues of co-operation, solidarity and brotherhood), conceptually and in this form, insurance is considered to be in consonance with the injunctions of Islam.

Though by virtue of inbuilt features of mutual cooperation and sharing, conceptually conventional insurance in its sprit is very much in line with Islamic fundamentals, its operational frame work has been declared by Shari'a Scholars in a Judicial Conference held in Makkah in Shaban, 1398 AH as un-Islamic (i.e. inconsistent with the principles of Shari'a). In the last few decades, similar Shari'a Fatwas and Resolutions of historical significance have been passed at various forums.

"Takaful" – an infinitive noun in Arabic having origin in the verb "Kafala" means "to guarantee or to bear responsibility for …". In simple terms, "Takaful" means an agreement wherein participants (members) of a group jointly guarantee each other to meet a defined loss/damage suffered by any one amongst them.

To a muslim, Takaful offers piety (in the form of making contribution for self purification), brotherhood (via ta'awun i.e. mutual assistance), charity (i.e. tabbarru meaning donation for a greater cause) and mutual guarantee (indemnification to the unfortunate ones amongst them for their loss/damage).

## Global Overview

Islamic finance is a growing phenomenon and holds 6% share of the global finance industry (2019) valued at nearly USD 2 trillion. In tandem with growth in Islamic finance, demand for Shari'a compliant products for mitigating and managing risk has risen significantly. From the inauguration of the first takaful company in Sudan in 1979, takaful products are now distributed in around 30 countries through over 300 operatives (2019). Total takaful contributions are projected to reach US$97 billion by 2030, if the current growth momentum is sustained.

Major takaful operators are concentrated in the GCC countries and Malaysia), which on an aggregate basis comprise about 45% of the total industry contributions (2015). Going forward, growth in takaful contributions is also expected from emerging centers of Islamic Finance like Indonesia, Egypt, Sudan, Bangladesh, Pakistan and African Sub-continent, which are opening up to takaful products. Compulsory insurance through legislation, as witnessed in certain GCC countries, is also expected to spur growth. Family takaful business, given its small proportion (less than 25%) in the total takaful contributions, also represents a major opportunity for growth for takaful operators.

However, despite impressive growth, takaful industry is less than 1% of the global insurance industry while Muslims represent around one-fifth of world population. Tremendous growth opportunities are yet to be fully tapped as indicated by lower market share of takaful as compared to Islamic finance penetration even in GCC countries and Malaysia.

While General Takaful has received greater impetus in the last few years, family takaful comprises a minimal proportion of life contributions globally. With support for the family and saving for major personal goals at its core, family takaful has evolved through a product suite that provides financial assistance to groups and individuals, while also offering unit linked investments that allow participants a full gamut of investment options.
As global insurance companies enter the takaful market through window operations, access to takaful as an alternate to conventional insurance gains further momentum. **Collective effort towards product innovation and pooling of greater industry resources is essential at the current stage of industry development. While this also represents enhanced competition, it does not necessarily impinge on room available to takaful providers for growth, given the nascency of the industry as a whole.**

## Fiduciary Ratings in Takaful

IIRA's fiduciary rating approach acknowledges the differentiating features of Islamic finance and Takaful and incorporates their implications on various assessment parameters. IIRA's concept of providing all stakeholders a wide range view of the assessed institution and as already detailed in its rating methodology for Islamic Banks (www.iirating.com), also finds application in Takaful firms. **Fiduciary ratings comment on the strength of the institution's business practices and their impact on financial indicators, as reflected in the takaful firm's capacity to protect the takaful participants.** IIRA's view on the firm's fiduciary capacity entails analysis of business strategy and policies as well as diligence exercised in business selection and mechanisms employed for diversification away of non-systemic risks. **In addition, the methodology calls for an evaluation of corporate governance systems in effect.** A significant component of IIRA's fiduciary rating methodology is an analysis of the Sharia governance infrastructure of the takaful provider and the degree of adherence to Shari'a related best practices.

**This document details the Fiduciary rating approach for both General and Family Takaful, in two distinct sections including Takaful Financial Strength Assessment and a Fiduciary Score.** The latter further devolves down to a two tiered score comprising an Asset Manager Quality Score which scales the financial resilience of the Takaful fund on a standalone basis and the governance and policy framework employed to achieve financial objectives.

A Sharia Governance Score is provided separately for greater information on Sharia related practices in effect, for increased information to stakeholders and participants. The methodology is also scalable to Re-takaful firms and highlights key differences in underwriting strategy vis-à-vis takaful firms, in the relevant section.

## Organization in Takaful

**IIRA believes that there are clear distinguishing factors between conventional insurance and takaful.** Amongst others these include, the structure and purpose of the takaful fund, prohibition of investment in non-Shari'a compliant avenues (conventional fixed income securities and equity investment in prohibited businesses and financial services) and most significantly, a fair distribution of risks and rewards which necessitates segregation of participants' fund and shareholders' fund.

Both General and Family Takaful require segregation of the Participants' and the Shareholders' pool in order to ensure a mechanism, whereby the participants as a group, have the incentive to avoid undue risks, take collective responsibility and share in the benefits of a diversified pool. More specifically, a takaful firm is organized with two funds; Participants Takaful Fund (PTF) and Shareholders' Fund (SHF). In Family Takaful firms, the participants' pool may further be distinguishable as Takaful and a Participants Investment Fund (PIF), with the latter linked to units representing participants' claim to investment returns. The independent nature of the PIF is a common feature between Takaful and conventional insurance. **The existence of multiple funds in both types of insurance organizations, requires clear separation between assets of each, as it could raise governance concerns stemming from potential conflicts of interest.**

In both family and general takaful, the shareholders appoint a Takaful Operator (TO) which is an independent proprietary entity and has considerable discretion in managing the PTF. The contribution received from a participant in a General Takaful undertaking is credited into the PTF (before or after deduction of Wakala fee as dictated by the model employed), and distributed between the PTF and PIF in family takaful firms. Given that the takaful operator acts as a manager for the 'Participants' Pool' and on account of risk sharing among takaful participants as opposed to transfer of risk to the TO, there is no contractual liability upon the TO to cover any loss/deficit arising in the PTF. However, SHF can provide Qard-e-Hasna (Interest free financing) to PTF, in times of financial stress. The regulatory framework in each jurisdiction gains significance here, since additional protection may have been provided to participants by obligating the SHF to cover for protection of participants in adverse situations, even though in principle, it is not liable to cover unavoidable losses. It is important to note that creating any such obligation or even a precedent of support, may be seen as offering greater ability to protect policyholders; however, it signifies a misallocation of rights and obligations from a Shari'a perspective and calls for evaluation in that context.

At the outset of assessing ratings for a takaful firm, IIRA evaluates the distribution of rights and responsibilities between the participants, the shareholders and the operator/manager. These are largely governed by the models employed in operating the takaful and also quite importantly, the regulatory framework, as highlighted above. The treatment of transfers from one fund to the other over the life of the funds and in the event of liquidation, sheds light on the true nature of such transfers and drives the rating assessment by defining 'obligation' in the context of a takaful firm. This has direct implications on the significance assigned to a firm's capital structure, and drives the importance of assessing each of the financial aspects of the firm on a standalone (fund by fund) or combined (PTF and SHF in aggregate) basis, as the case may be.

Further, depending upon the model employed, certain assessment parameters acquire less or more significance in evaluating the ability of the firm to discharge its responsibilities. Illustratively, where management fee is directly deducted from contributions, an assessment of takaful surplus will call for a view distinct from a model where takaful surplus contributes towards it, and/or the shareholders' fund undertakes the responsibility to meet expenses. Absence of discipline to generate sufficient surplus to meet management expenses might result in losses for the shareholders' fund if support from investment income is limited. To illustrate this further, Takaful models employed by both Family and General Takaful firms are outlined here.

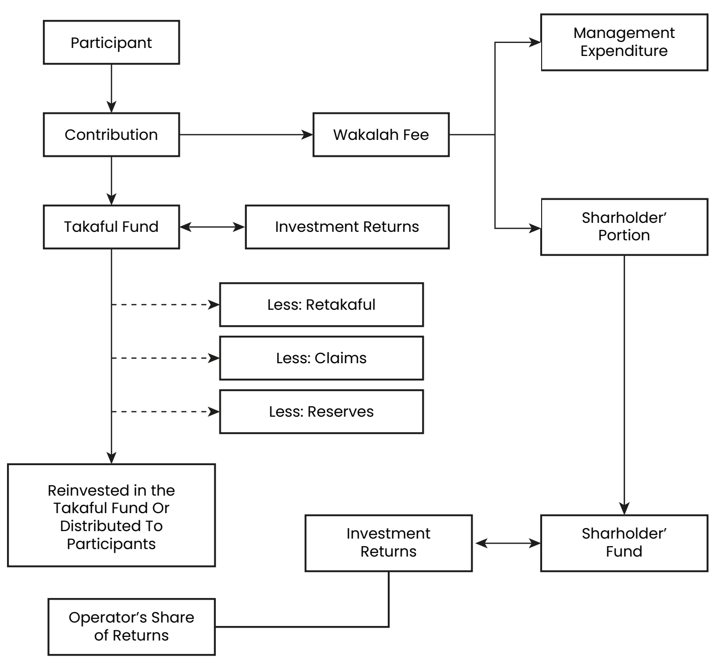
# Takaful Models

There is no single operating model that is used by takaful operators across the world. However, most of the takaful companies are based on four different operating models i.e. Waqf, Al-Wakala, Al-Mudharaba and Hybrid model (a combination of Wakala and Mudharaba). In all these models the surplus in participants' fund belongs to the members or participants, whereas the shareholders have claim on the surplus in the shareholders fund. Except in cases of negligence, losses from operations are to be borne entirely by members of the takaful fund, while Qard-e-Hasna may also be extended if needed. Practically, the regulatory framework in most jurisdictions provides participants with recourse to shareholders' funds in case losses are incurred. In all the three models, there exists a mechanism of recourse to the SHF on an ongoing basis, and it therefore becomes important to analyze all financial indicators on a consolidated basis. Risks specific to each model are assessed separately.

# Al-Wakala

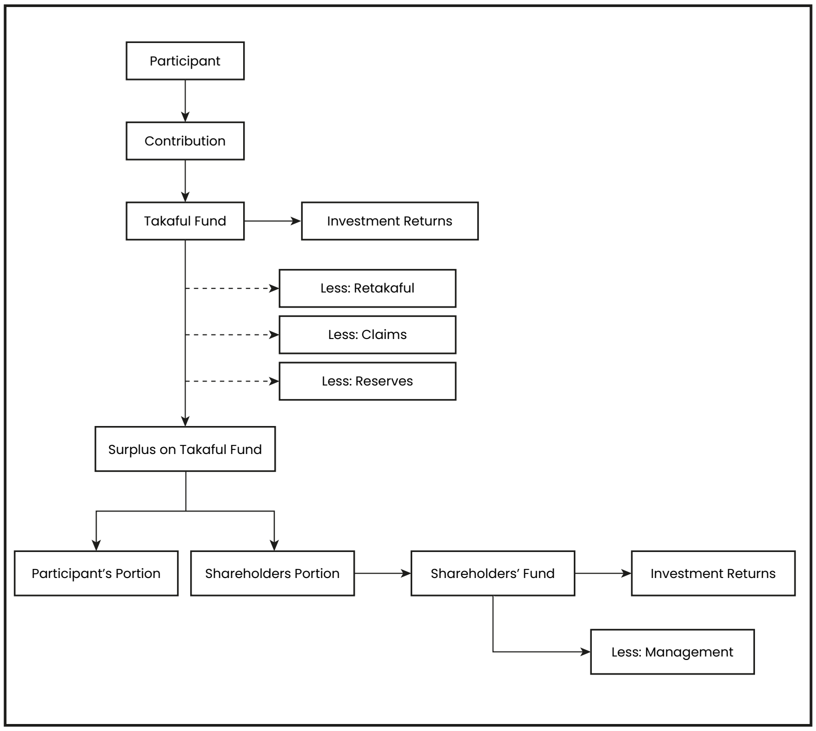
Al-Wakala is a fee-based model in which an agency relationship is agreed between two parties to conduct a certain business undertaking. In this model, the Takaful Operator (TO) is eligible for a fee from takaful contributions generated by the takaful fund. The fee is a percentage of takaful contributions and is pre-agreed and stated in the takaful contract. Shareholders do not have a claim on the surplus of takaful fund. In addition to Wakala fee, the Takaful Operator may include a performance incentive fee. In this model, IIRA would place a relatively lower reliance on surplus generated by the participation fund, which does not contribute to the strength of the shareholders' pool and which may in turn be drawn down upon, in adverse circumstances. Since the surplus is also not required to fund management expenses, which are covered by Wakala fee, surplus in PTF is largely important in the context of its contribution to strengthening the Takaful fund to the extent that it is reinvested. From a Shari'a compliance perspective, distribution to policy holders is the most equitable allocation of surplus in the participant's fund, and may also be utilized to reduce future contribution. With respect to shareholders' fund, discipline to operate within cost structure is important for profitability of the fund.

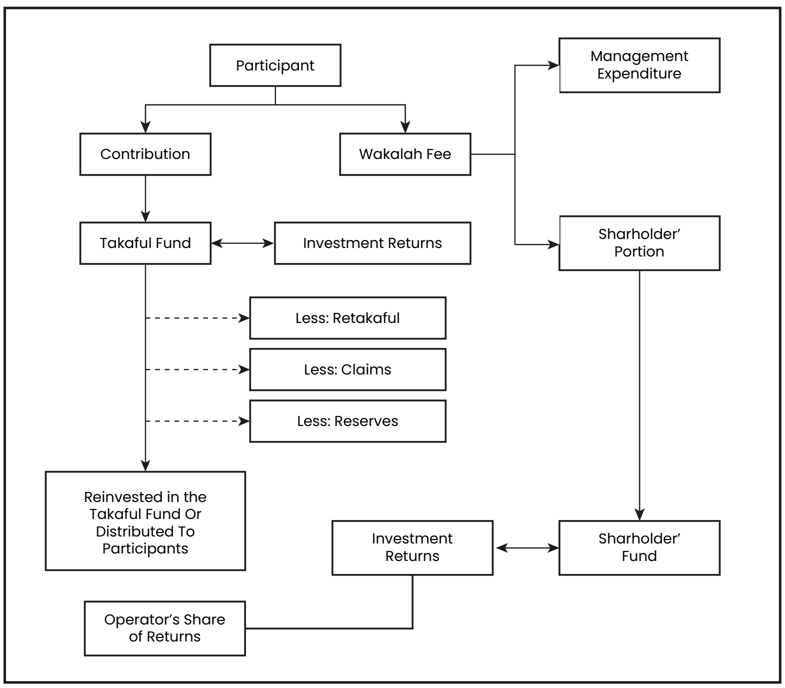
**http://www.islamicbanker.com/takafulmodel**



## Al-Mudharaba

Under the Mudharaba arrangement, a contract is signed between the TO and participants in the takaful fund. The TO or Mudarib is responsible for managing underwriting and investment activities on behalf of the members of the takaful fund. For its services, TO receives a mutually agreed ratio of underwriting surplus and/or investment returns as per the contract while losses are absorbed by participants. This may act as an incentive for the operator to improve underwriting performance.



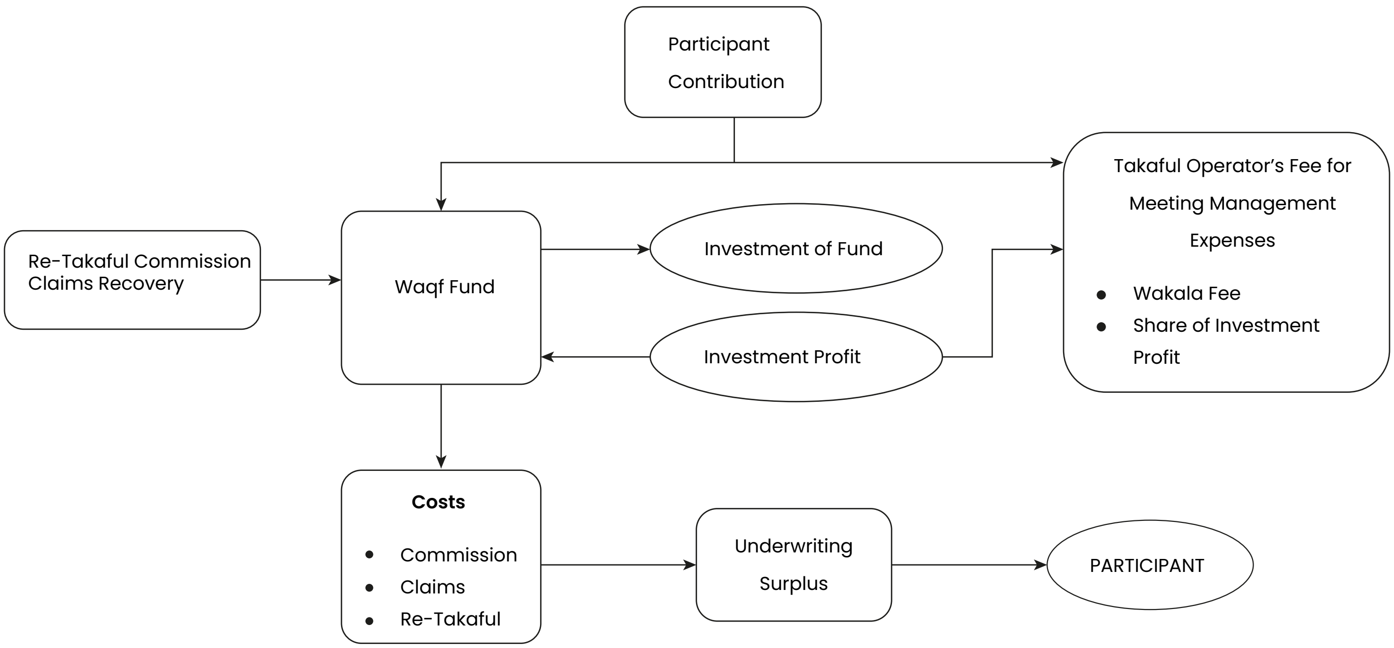

## Hybrid Model

Over the years a number of variations which employ combinations of the above two models have evolved. The most common model adopted is a hybrid of the Wakala and Mudharaba structures, whereby the Wakala contract is adopted for underwriting operations while the Mudharaba contract is negotiated for investment activities. The hybrid model has also been recommended in AAOIFI guidelines.

## Waqf Model

While the Waqf model in its original form has been applied in fewer jurisdictions, a Wakala-Waqf model is being used in Pakistan, South Africa and also by Swiss Re Retakaful. The model works similar to a Wakala model in most respects. Under this model, a cash Waqf fund with an initial donation (seed money) is created for the purpose of extending financial assistance to members in the event of loss. Since the Waqf is created to serve as a separate legal entity, the contribution made by the participants belongs to the Waqf. Participants' contribution is an unconditional donation, and they lose any right of ownership to their contribution.

However, the relationship is not fully unilateral, as the right of participants with respect to surpluses and indemnifying them in case of losses are clearly laid out in the Waqf deed. The takaful operator will perform all functions necessary for the operations of the Waqf against a Wakala fee to be deducted from the contribution paid by the participants while underwriting and operational cost of takaful will be charged to the Waqf fund. Surplus distribution mechanism is also laid out in the guidelines for the Waqf fund.




# IIRA's Rating Approach

The key philosophy behind IIRA's rating methodology is to evaluate a Takaful business in terms of its capacity to discharge all its Fiduciary obligations and in a manner that conforms to best business practices and Sharia' precepts. IIRA therefore assigns a Financial Strength Rating and a Fiduciary Score, which together covers the strength of the business and the manner of its conduct in a cohesive manner. The Financial Strength Rating focuses on the firm's capacity to protect participants in the event of losses and generate positive investment returns. Amongst several financial and managerial indicators viewed for both pools on a consolidated basis, this may also take into account the possibility of shareholders' or promoters' support.

The fiduciary score measures the management's capacity to manage the takaful and Participants investment portfolio on a standalone basis and fairly assign surpluses and returns to the participants. In common with the Financial strength rating explained in the preceding paragraph, this also requires an evaluation of underwriting diligence and prudence in investment decision-making, with an enhanced focus on its translation into consistently robust results being generated over the years, in keeping with market norms and reflective of prudent decision making. It further takes into account the management and board practices in effect, with a view to fairly accommodate the interest of all stakeholders. The fiduciary score also constitutes a Shari'a compliance score, based on a firm's conformance to Shari'a guidance by standard setting agencies dedicated to the furtherance of Islamic finance and the views/edicts as pronounced by the institution's own Sharia advisory body or a central regulatory body, as the case may be. The fiduciary score is derived from the above two elements i.e. asset manager quality which has a 75% weight in the overall fiduciary score while the other element is Shari'a governance with a 25% weight.

| Takaful Fiduciary Rating | | |
|---|---|---|
| Financial Strength Rating | Fiduciary Rating (Score) | |
| | Asset Manager Quality (75%) | Shari’a Governance (25%) |

## Financial Strength Rating

A Financial Strength evaluation is essentially forward looking in nature and involves a view on the long-term participant protection ability of the company. In addition to external factors such as regulatory framework, market position and degree of competition, the rating assessment will also incorporate firm specific characteristics such as the competence and experience of the management team, product risk & diversification, liquidity profile, the level of capitalization & quality of re-takaful arrangements. Analytical parameters used for all three types of takaful, i.e. family takaful, general takaful and Retakaful remain largely similar and have been differentiated only in the section on ‘Underwriting’, where business profile of each class of takaful has been explained and which is notably distinct from each other.

While there have been some developments on the regulatory front, including takaful specific regulations, including solvency and minimum capital requirements; these vary significantly across countries. Ratings will be mindful of developments in the regulatory framework and other changes in the external environment. Moreover in countries where regulation is considered weak, extra credit, might be factored in the ratings for additional commitments in favor of policyholders.

## Organization Structure, Management and Controls

The overall organization structure, including oversight performed by the board and its effectiveness in terms of exercising due controls is the starting point of the analysis. The coherence of the business strategy, its communication to the management and its on-going implementation is evaluated to appreciate the firm’s potential direction.

The experience and track record of the management in delivering success is an indicator of the business’s future health. Clarity in an organization’s distribution of responsibilities, cohesion of effort and streamlined policy direction is an essential ingredient to smooth functioning of the firm. It is important to highlight the significance of an effective internal control system at this point on account of its direct relevance to the institution’s long-term financial health.

## Underwriting Strategy

The underwriting strategy and prudence in its implementation, forms the core basis of business viability. The interplay of diversification in risks and the quantum of individual risks, determines the intrinsic participant protection ability of the company. Business growth is viewed not just in the context of its likely favorable impact on the overall surplus position but equally if not more in terms of the drivers of this growth. Illustratively, if significant growth in contribution base has been led by excessive risk taking, a conservative assessment of impact of growth on earnings profile of the company will be taken.

***General Takaful*** policies generally reflect short-tail risks and provide relief against specific adverse events. Business mix of an institution is reviewed in terms of the extent of exposure to classes of business that have high loss norms. Apart from sizeable exposure in a particular location or a type of risk, concentration related risks may arise from positive correlation between different classes of business also; the same are required to be controlled by the management.

In addition to analyzing the loss norms for each class of business on a timeline basis, stacking of loss norms for a particular class vis-à-vis that of the other players in the industry may provide a yardstick for assessing the underwriting practices of the organization. Risk profile of any class of business may change over time; responsiveness of management to revise its underwriting guidelines or contributions taken from participants, is also taken into consideration in the rating assessment.

Family Takaful operators provide individual and group policies and regular & single premium policies. Individual Family Takaful risks are more long-tailed as compared to Group Family Takaful exposures, which has implications for the volume of renewal contribution that a company generates. Average life of individual family takaful policies will be tracked by IIRA to determine the volume of renewal contributions that will be generated by the company over the long term. With most unit linked policies, as is also the case in conventional life insurance, much of the asset risk is transferred from the shareholders to members of the takaful fund.

Individual regular contribution policies are considered the lifeblood of a Family Takaful business, given the stable cash flows and high persistency associated with these policies. With contributions received at the outset in case of a single contribution policy, management expense tends to be lower for the same. However, given the additional focus of single contribution policies on investments, these are more prone to surrender under depressed market conditions while regular contribution policies take time to build substantial cash values and are more protection oriented. Surrender rate could also increase in case of regular contribution policies if markets are doing exceptionally well; this can be logically expected in a scenario where cash values have surpassed the sum risk assured by a reasonable margin. Along with the type of policy, the time taken to build cash values depends on the return on investments in the country. All investment-linked policies generally expose takaful companies to a certain degree of market risk.

For a Family Takaful operator, high proportion of individual policies is an indicator of healthy business mix and outreach of the company. Due to granularity of Family Takaful risks and need for a sizable distribution network to underwrite significant quantum of individual family business, optimal mix is generally evident in mature Family Takaful companies and justifies higher ratings.

Role of actuarial analysis is critical in determining the pricing of policies. A detailed study of all information pertaining to characteristics of the participants, maturity period, benefits, type of payment, mobility and mortality rates determine the cost of the takaful plan.

Re-takaful operator indemnifies a takaful company against risk underwritten and is also referred to as 'takaful for takaful companies'. Besides increasing underwriting capacity, the major advantages of re-takaful for a takaful operator include reduction in risk and in turn liability, stability in net loss terms, and protection against catastrophic losses. Re-takaful contracts are based on treaty and facultative arrangements. Facultative policies are generally underwritten for large and unusual risks and treaty terms are negotiated separately for each policy. Each risk is evaluated separately for facultative arrangements and the contribution is charged according to the risk inherent in the policy. Since individual risks assumed are not assessed separately in case of treaty business, the re-takaful operators' assessment of underwriting quality of takaful company impacts pricing. Given the differences in nature, size, risk and underwriting capabilities required for the two policies, risk evaluation for each type of policies is undertaken. For facultative arrangements in particular, expertise in risk appropriate underwriting and onboarding of specialists from multiple fields where the re-takaful firm takes exposure is considered important. Resultantly, employee related costs and administrative expenses, since each policy is evaluated individually, is higher for facultative arrangements. Business mix is therefore as important for retakaful firms as it is for takaful firms.

The operations of a re-takaful operator are very similar to that of a takaful firm. The re-takaful fund receives contributions from each participating takaful fund and distributes surplus from investing and underwriting activities on the basis of one of the models highlighted above. In case of deficits, re-takaful operator may extend Qard-e-Hasna to eliminate shortfalls.

A takaful/retakaful company's market position and franchise value is given due consideration given the direct bearing on profitability due to economies of scale that firms with larger market share enjoy. Franchise value assessment also incorporates attributes such as brand image and other competitive advantages which help firms withstand prolonged market challenges.

## Indicators Used

- Unit linked Assets to Total Assets
- Diversity in product offerings
- Underwriting mix, evaluated in the context of loss norms
- Contribution receivable in relation to gross contributions

## Distribution

With particular reference to family takaful business, strength of various distribution channels for improving penetration in the individual family takaful segment is considered important. Therefore, a wide and strong retail distribution network is essential for high persistency and to build viable business volumes. Universally, bancatakaful and company's own sales force are the two major channels for distribution of family takaful policies. Persistency rate in terms of policies and contributions for both channels of distribution is an important indicator to evaluate the confidence of policyholders in the company. For the sales force channel, productivity will also be evaluated using various productivity ratios (number of policies sold by an agent per month). Tenor of policies sold through both channels will also be monitored to project renewal contributions.

## Indicators Used

- Diversity of distribution channels
- Distribution Control
- Distribution Productivity
- Growth target and its achievement by line of business

## Re-takaful

Re-takaful constitutes a major source of external support that can be tapped on to meet participants' losses, particularly in case of general takaful business. With much lower growth in re-takaful business than initially expected and also in relation to growth in takaful operations, re-takaful arrangements are a major challenge for the industry. A scarcity of quality re-takaful operators and their relative lack of capacity can expose firms to concentration related risks and force the company to retain greater risk on net account. Consequently, Shari'a scholars have allowed re-insurance support from conventional reinsurers. A number of takaful companies have turned to co-takaful to reduce reliance on conventional reinsurers.

IIRA will closely examine quality of re-takaful insurers on a company's panel and terms of re-takaful arrangement for balance sheet protection when determining the financial strength of a takaful company.

Given that cession in individual family takaful policies in a number of jurisdictions is on the lower side, the importance of re-takaful will not be as significant, in the context of Family Takaful firms as in case of General Takaful.

## Indicators Used

- Retakaful Ceded/Gross Contributions
- Net Retention
- Treaty terms by reinsurer, limits, loss sharing, commission rates etc
- Credit Risk Analysis (Ratings of Reinsurers)

# Capitalization

Given that the participants' and the shareholders' interests are represented by separate funds, each fund is assessed by comparing its surplus to its obligations. Accounting for the recourse that participants may have to the SHF, in the form of Qard-e-Hasna, in times of stress, higher financial strength of the SHF in relation to the PTF will enhance IIRA's estimation of capitalization indicators on a firm wide basis. Resorting to drawing Qard-e-Hasna is particularly common in a firm's early phase of operations.

The nature of the Qard-e-Hasna facility extended to the PTF is such that it may not be redeemable in the foreseeable horizon and its repayment is conditional upon the scale of losses incurred by the PTF. Generally, repayment of Qard-e-Hasna ranks secondary to the payment to be made for protection of participants, although this also varies from jurisdiction to jurisdiction and has implications for whether it will be deducted from the firm's capital, to calculate its capital adequacy. On the other hand, the PTF is ring-fenced and weak financial strength of the SHF will not burden the financial strength of the PTF.

An important distinguishing feature of a takaful firm is that surplus generated by the takaful firm is distributable to the participants of the fund. However, this is subject to approval of the appointed actuary for family takaful operators which takes into account future participant protection capacity in view of past underwriting quality, policy on surplus retention and distribution and adequacy of reserves. Reports issued by the appointed actuary on the financial standing of the takaful fund would also be reviewed.

While evaluating capital sufficiency, consideration will also be given to past capital accumulation trends, which will result in creation of a contingency reserve. The higher the reserve the better will be the ability to protect participants and the greater the balance sheet strength. Decrease in contingency reserve can adversely impact a company's financial profile and flexibility. Any documented policy and actual trends with regards to retention of surplus within the takaful fund will also be factored into the ratings. Apart from internal capital generation, a company's ability to raise capital from external sources to meet unexpected obligations is also considered as part of the capitalization assessment.

Based on various risk factors that may impact the capital requirements of the company vis-à-vis its existing risk base, IIRA computes capital adequacy of takaful companies. Risk factors include adequacy of loss reserves, risk emanating from underwriting operations and product mix of the company, non-payment risk arising both from receivables on books and the investment portfolio, price risk on equities and profit rate risk in the investment portfolio.

## Indicators Used

- Capital/Total Assets
- Capital / (Crude Death Rate x Net Sum Assured of Individual Life)
- Financial Leverage
- Cash flow from Operations
- Risk Based Capital Adequacy Ratio
- Financial flexibility and Access to New capital

# Credit, Market and Liquidity

Given the uncertainty associated with liability payout stream of a takaful fund, (particularly in case of general takaful) the presence of adequate liquid assets is considered an important rating factor. Besides investments, which are a secondary source of cash flow, liquidity is primarily supported through a firm's operating cash flows (including re-takaful recoveries). Therefore, credit risk associated with contributions receivable and investments are both important factors to be considered.

In case of general takaful policies, re-takaful arrangements are a noteworthy support to the company's ability to meet policyholder demands. Uncollectible re-takaful receivables can impact a firm's profitability. Consequently, monitoring of the amount of re-takaful recoverable and an analysis of the credit quality of re-takaful operators is vital. In the eventuality that there is a delay or lack of payment by the re-takaful company, the cash access of a takaful firm can be severely limited. Aging of contributions due but unpaid is also incorporated in the liquidity assessment. Liquidity profile is tracked for the takaful fund as well as on a firm wide basis. With respect to family takaful policies, particularly incase of individual policies where persistency rates are high, liquidity requirements in a given year are usually not significant.

Assessment of liquidity profile of assets varies with market conditions for the avenues in which the company has invested. As it is mandatory for takaful companies to invest in Shari'a compliant avenues, investment opportunities (including Sukuk) are limited. Resultantly, concentration in equities & in a particular geographic region and counterparty risk tends to be on the higher side as compared to their conventional counterparts. This has implications for the risk profile of a takaful operator. A diversified investment portfolio can enable a company to better withstand deterioration in a single asset class.

Policies for liquidity management should also be put in place and contingency plans should be outlined for meeting liquidity requirements under stressed conditions. Additionally, policies with respect to payment of Wakala fee and surplus distribution should incorporate liquidity requirements of the company.

### Indicators Used

- Liquid Assets (Haircut on listed equities and excluding real estate & unlisted equities)/Total Obligations
- Balance Sheet Composition (% of non-earning assets)
- Concentration related risk
- Technical reserve Coverage
- Credit and market risk of financial assets (investments)
- Ageing analysis of receivables and counterparty credit risk

## Profitability

Sustainable profits are a fundamental determinant to a takaful operator's ability to protect participants. IIRA conducts a separate analysis of the profitability of the PTF and SHF. Profitability of a takaful operator and the participants' fund remains a function of underwriting and investment strategy. IIRA evaluates fund performance of a company using various profitability metrics, including loss experience, expense ratio, and investment yields.

Geographic outreach and diversification across business segments & product lines can result in stable earnings. Expense base of the company is compared on a timeline basis, in relation to contribution retained and with peers having similar contribution base to form a view regarding the institution's operational efficiency. Benchmarks for expense ratio of the company may vary from large-sized companies to small companies. Investment performance is critical to the overall profitability of the takaful company.

For Family Takaful operators, high persistency rates are a key driver of profitability. Persistency rates indicate a firm's policy retention levels. Generally, persistency rate of 90% and above are indicative of strong retention ability of a family takaful operator. The tax implications on surrenders can have a significant impact on persistency rates as is the case in certain jurisdictions where persistency is on the higher side due to the adverse tax effects in case of surrenders in the initial years of policy issuance.

As takaful operates on the principle of cooperation and solidarity, neither fund is meant to generate excessive profits. In order to examine this, IIRA will note the fee charged or share of profit between the SHF and PTF. Given that most TOs are themselves the trustee, they have significant discretion in determining Wakala fees. Good governance would require approval of Wakala fees from the governance committee of the Board of Directors or the BoD itself.

The performance of the shareholders' fund is viewed primarily in the context of its ability to generate returns sufficient to enable efficient and effective management of the two funds and in certain circumstances support the participants' fund. It may be reiterated here that in case the financial position of SHF is weaker relative to participants' fund, better financial position of PTF may not be considered to offset that of SHF, as support can only be extended by SHF to PTF and not vice versa. While strong performance in the shareholders' fund may compensate partly against losses in the PTF, a weak shareholders' fund will limit Financial Strength Ratings.

### Ratios Used

- Net Claims Ratio
- Expense Ratio
- Combined Ratio
- Return on Equity ((Profit After Tax - Surplus Transferred +Surplus Earned)/(Reported Equity + Accumulated Surplus)

## Asset Manager Quality

In its role as Mudarib, TO is a custodian of contributions provided by members of PTF. Resultantly, it has a fiduciary duty to ensure that contribution from PTF members are invested in Shari'a compliant avenues in a prudent manner so that takaful benefits can be paid to participants as per the takaful contract as well as expectation of participants.

The assessment of the Takaful firm as an asset manager does not rely on the support that may be available in times of need from external sources. Rather it focuses on its intrinsic strengths, cultivated as a result of sound management practices and manifested in strong financial indicators in all of the areas referred to above. This implies that the Asset Manager Quality assessment duplicates evaluation of financial strength indicators, as an illustration of sound practices and governance. However, it focuses not just on protection and returns as proof of strength, but on optimization of returns being generated and fairness of distribution.

With the concept of risk sharing among takaful participants as opposed to risk transfer from the participant to the TO; takaful operators may face a number of interest conflicts, unique to their structure. For instance, TOs are appointed by the shareholders with an objective of maximizing shareholder value, which may conflict with the objectives of takaful participants towards whom the TO has a fiduciary duty. This might be more pronounced in organizations with a weak governance structure, given that there is no formal mechanism for members of takaful fund to influence decision making by the TO. IIRA believes that a comprehensive governance framework identifying and segregating the rights and duties of each stakeholder will help inculcate a culture of accountability within the organization. Given the significant discretionary powers enjoyed in managing the takaful fund, it is essential that a Code of Ethics for business conduct is adopted by TOs. The IFSB code of conduct on business for Institutions offering Islamic Financial Services can also serve as a guiding principle in this regard.

In order to fulfill its fiduciary duty, TO should ensure that an effective risk management infrastructure is in place, responsible management of assets appropriate to the nature and profile of takaful fund objectives is being undertaken and prudent investment limits are in place. The ultimate accountability for the investment performance of the takaful funds lies with the BoDs. Therefore, all investment and risk management policies must be approved by the board of directors.

Given that there might be differences in investment strategy for the two funds, the investment policy should develop clear investment objectives. Investment policy for the two funds, should be based on their specific objectives. The policy should also identify the asset allocation and review mechanism for PTF and SHF. Separate investment policies should be developed for Family and General Takaful business on account of different nature of obligations.

Apart from a sound investment policy, TO should also establish a risk management framework for identifying and monitoring risk in an integrated manner. Furthermore, takaful operators should also ensure that investment portfolios of both funds are in line with Shari'a guidelines.

**2 http://www.ifsb.org/standard/IFSB-9_Guiding%20Principles%20on%20Conduct%20of%20Business.pdf**

Another important aspect of good corporate governance in a takaful concern is for the TOs to ensure that a mechanism for sustaining the solvency of a takaful undertaking is in place. As mentioned earlier, the TO has considerable discretion in managing the PTF. This can encourage TOs to maximize their remuneration (through Mudarib's share) by generation of significant underwriting surpluses or maximizing Wakala fees without accounting for the risk implications of a takaful participant. Moreover, depending on the insolvency law of the jurisdiction in which the firm operates, the insolvency of a takaful undertaking may be independent of the insolvency of the SHF. This may impact the interest of members of takaful fund as the shareholders' may not give adequate consideration to the insolvency of PTF. In order to address this issue, appropriate policies should be in place on maintaining reserves, surplus sharing, distribution of underwriting surplus/ deficits and treatment for undistributed surplus, which should also be disclosed in the annual report. These policies should also be approved by the BoDs and SSB.

The future strategy of the entity and how it is communicated to all levels of an organization is significant and yet the most intangible of all rating factors. Continuity of strategy as a result of stability in management is also factored into the ratings. An entity's organizational structure is also reviewed to evaluate whether job definitions, roles and responsibilities are clearly defined. Control measures undertaken by the management including policies & procedures and contingency plans in effect and the degree of centralization will be assessed in addition. The IT systems deployed play a key role in facilitating timely decisions and its business support function is considered essential to effective management.

Corporate governance practices are evaluated in the following broad areas;

## Board Effectiveness

The challenge of good corporate governance within a takaful company is in balancing the interests of PTF members with that of shareholders. This can be done through fair access to information for all stakeholders and establishment of appropriate governance structures. The latter is the responsibility of the Board of Directors which must also oversee its implementation. While evaluating overall governance structure, IIRA will review independence, composition, profile and degree of involvement of board members. Strategic direction set by the board including selection of management and succession planning, risk targets and oversight of financial reporting are factors which provide important information regarding governance standards. Board members with relevant experience are deemed to be instrumental in formulating the strategic objective of the organization. Moreover a governance committee at the board level should be formed with the purpose of dealing with conflicts and reconciling the interest of shareholders and participants. One such instance could be when the terms and conditions of a Qard-e-Hasna are being finalized. Since participants are not involved when such arrangements are being made TO is in a position to finalize such terms to its advantage unless there is involvement of the governance committee. Representation of participants and Shari'a Supervisory Board members should be ensured in the governance committee.

## Management Profile and Operations

Management and organizational structure is an important element in an overall evaluation. Experience and skills of upper management including the availability of technical resources for underwriting specialized risks, stability of management and its compatibility with the strategic vision of the board will be closely evaluated. Furthermore, management's relationship with shareholders, regulators, employees and policyholders is further an area of consideration.

## Self Regulation

Self regulation includes areas like IT support, control infrastructure, compliance and risk management. Presence of audit committee ensures a sound internal financial control environment. Meanwhile audit committee also monitors the performance of the internal audit function by approving the annual audit plan, reviewing audit reports and also appoints external auditors. A strong internal audit and risk management division is central to an institution's self regulation capacity.

Non-compliance with regulations may impinge on operational viability of the company. Establishment of an effective compliance department to monitor compliance with regulations and ensuring permissibility of source of money transfers and business accepted, may prevent regulatory sanctions.

## Disclosure Standards

Appropriate disclosures and access to relevant and material information results in effective checks and balances and also helps prospective members of the takaful fund in understanding the risks to which they may be exposed. Best practices in terms of disclosures entail adoption of AAOIFI or some other appropriate international accounting and financial disclosure standards and annual report disclosures such as the takaful model employed, information on investment performance and various sources of risk for present and prospective takaful fund members.

## Shari'a Compliance

Strong Shari'a Governance paves the way for effective compliance with the guidance provided by Shari'a supervisors and ensures conformance with the fundamentals of Islamic jurisprudence. Non-compliance with Shari'a principles poses significant reputational risks to firms, founded on the principles of Shari'a. In extreme situations it may result in erosion of franchise and ultimately cancellation of policies, causing reversal of contribution booked. In case of family takaful companies, risk emanating from loss of franchise value may be more pronounced as it may result in premature cancellation of policies, leading to liquidity pressure. Regulatory action may also be instigated in case of breach of Shari'a principles. Thus, instances of material Shari'a non-compliance may translate into risks that have a dampening effect on the overall financial strength assessment of the institution. IIRA will track the following broad areas in its Shari'a Compliance Assessments:

## Shari'a Supervisory Board

IIRA believes that a strong Shari'a infrastructure stems from the company's Shari'a Supervisory Board (SSB) and will study the education and experience profile of members of SSB and their role in the evolution of Shari'a audit & compliance framework. Shari'a pronouncements may vary across jurisdictions, therefore, IIRA's evaluation is restricted to compliance with Shari'a principles as adopted by the institution under advice from its SSB, in addition to governance related parameters. While IIRA does not perform an audit of such compliance as part of the rating process, it relies on Shari'a audits conducted internally and the level of vigilance exercised by the Shari'a board. Approval from Shari'a personnel or the Shari'a Board should precede any revision in underwriting guidelines or introduction of any new takaful product; underwriting processes should ensure that there is no negligence in this regard. Guidance is taken in this respect by the best practices laid out by AAOIFI and the IFSB and the primary focus is on the degree of conformance to the delineated standards.

## Shari'a Supervisory Board

Functioning of the Shari'a audit and compliance department to assess effectiveness of the internal audit processes and the thoroughness on the part of the management team in identifying and rectifying Shari'a related observations are also taken into account. In this regard, audit planning and methodology, audit conduct and the reporting line of the Shari'a audit and compliance department are important areas of consideration.

## Surplus Distribution

Subject to the Takaful model in use, the legitimacy of surplus allocation is a key area of evaluation from a Shari'a perspective. By rights, surplus in the participants pool is the property of the policyholders and therefore, an efficient, fair, and transparent system of surplus distribution, and the treatment given to undistributed surplus is the most significant assessment area of Shari'a governance. Track record in surplus distribution is evaluated, with ratings favorably affected by a high proportion of surplus being distributed, in a timely manner. Treatment of undistributed surplus or policies in case of liquidation of the company, clearly establishing the right of policyholders to the surplus are considered important from a fairness standpoint and thus carry significant weight in the evaluation process.

## Profit Purification Mechanism

This is a significant area in terms of overall assessment of Shari'a Governance. IIRA will evaluate company's income against its stated policy of how Shari'a non-compliant earnings and expenditure can occur; the volume of such income over the years will be tracked. The presence of an investment screening criteria is also considered important in this respect. It is to be ensured that contribution received is intended for activities, which are not prohibited by Shari'a. Moreover, a hierarchy of business acceptance should be established which ensures that conventional financial arrangements like for re-takaful should be utilized as a matter of last resort.

## Transparency and Disclosure Standards

As participants share the losses in the underwritten pool, the obligation of the TO in terms of keeping participants informed is far greater than the obligation of an insurance firm towards the insured. Risk management strategies, policy directions and information pertaining to the evaluation of the risk portfolio, should be disclosed and the right of participants to be informed must be acknowledged. Disclosures available on the website, annual report or otherwise available in the public domain will be closely reviewed for takaful firms during the rating process.

Eventually, the orderliness of the system of Shari'a compliance in terms of the policies in effect, awareness of basic principles of Sharia in all staff and their implementation in all functions is an integral part of the Shari'a Governance assessment. A sophisticated understanding of Shari'a in senior management, product innovation & research teams and training of employees to keep them abreast with market developments, further ensure inculcation of best practices. An organization with appropriate systems, processes and controls that minimize Shari'a non-compliance risk, is most likely to obtain high fiduciary scores.

## Glossary

**Takaful -** Takaful can be defined as a Shari'a compliant cooperative risk sharing arrangement whereby individuals in the community jointly secure themselves in case of future adverse events. It is based on the core principles of Tabarru' (contribution in the form of donation for fulfilling mutual obligation of protection of participants in case of losses), Ta'awun (mutual assistance) and prohibition of riba (usury)

**Tabarru -** Premium in a conventional insurance policy. An Arabic word for donation, gift or contribution. In the Takaful contract, this is the amount contributed for the purpose of participating in Takaful scheme.

**Takaful Operator (TO) –** An entity responsible for underwriting and managing the takaful business

**Takaful Participants –** A party who wishes to have cover against the risk of suffering a financial loss and participates in the Takaful product with the TO by paying a contribution. Takaful participants have a role similar to "policyholders" in conventional insurance

**Participant Takaful Fund (PTF) -** A fund to which the entire contribution or a portion of contributions paid by the Participants is allocated for indemnifying participants against losses

**Participant Investment Fund (PIF) -** A fund to which a portion of contributions paid by Participants is allocated in case of Family Takaful business for investments

**Qard-e-Hasna –** An interest free loan from the takaful operator for meeting shortfalls/deficits in the PTF

**Underwriting Surplus or Deficit –** The net result after indemnifying participants and covering for the operational cost of takaful/re-takaful

**Fiduciary Score -** A two tiered score comprising an Asset Manager Quality Score which scales the financial resilience of the Takaful fund on a standalone basis and the governance and policy framework employed to achieve financial objectives while the second component is the Sharia Governance Score which is provided separately for greater information on Sharia related practices in effect, for increased information to stakeholders and participants.

# Takaful Financial Strength Rating Scale and Definition

IIRA uses a scale of AAA to CCC to rate credit worthiness of the takaful companies with AAA being the highest possible rating and C- being the lowest possible rating.

- AAA: 'AAA' rated takaful companies have the strongest financial strength and strongest capacity to meet policyholder and contract obligations. Unfavorable business and economic conditions are unlikely to distress this ability.

- AA: 'AA' rated takaful companies have very strong financial strength and a very strong capacity to meet policyholder and contract obligations. No material change in this capacity is expected due to unfavorable business and economic conditions in future.

- A: 'A' rated takaful companies have strong financial strength and a strong capacity to meet policyholder and contract obligations. An adverse change in business and economic conditions may slightly affect this capacity.

- BBB: 'BBB' rated takaful companies have adequate financial strength and sufficient capacity to meet policyholder and contract obligations. However, unfavorable business conditions can affect the firm's financial strength.

- BB: 'BB' rated takaful companies have marginal financial strength and a low capacity to meet policyholder and contract obligations. The entity remains vulnerable to changes in the business and economic environment.

- B: 'B' rated takaful companies have weak financial strength and a weak ability to meet policyholder and contract obligations. The entity requires favorable business conditions to ensure payments.

- CCC: 'CCC' rated takaful companies have very weak financial strength and a very weak capability to meet policyholder and contract obligations. The firm is unable to benefit from prospective improvement in the economic environment.

- CC: 'CC' rated takaful companies have extremely weak financial strength and the weakest capacity of meeting policyholder and contract obligations.

The obligations rated BBB- and above are considered investment grade while obligations rated BB+ and below are of speculative grade.

## Fiduciary Scores

**(91-100) – Very Strong Fiduciary Standards**
(91-93), (94-97), (98-100)*

Rights of various stakeholders are well protected and the overall governance framework is strong.

**(76-90) – Strong Fiduciary Standards**
(76-80), (81-85), (86-90)*

Rights of various stakeholders are protected. Minor weaknesses have been identified in the overall governance framework.

**(61-75) – Adequate Fiduciary Standards**
(61-65), (66-70), (71-75)*

Rights of various stakeholders are adequately protected. Certain weaknesses have been identified in a few governance related areas.

**(40-60) – Basic Fiduciary Standards**
(40-46), (47-53), (54-60)*

Rights of various stakeholders are relatively vulnerable. Significant weaknesses have been identified in the overall governance framework.

**(Less than 40) – Low Fiduciary standards**
Rights of various stakeholders are at high risk and the overall governance framework is weak.

***Apart from the lowest score range, all score ranges have been split into three sub-divisions for further clarity**

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