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Global Trends coming to the **U.S. Insurance Market**

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Islamic Insurance

Takaful insurance is growing quickly in the Muslim countries and is now offered in the



on the Rise

heavily e U.S.

By Bevrlée J. Lips

When looking at the global landscape, you can't help noticing a rising star on the horizon. While economies have seen downturns and the screws on financial organization revenues are tightening like never before, there is one element of the insurance sector that is not only seeing significant growth but also represents potential reminiscent of the California Gold Rush.

In North America, having insurance is part of everyday life. Buy a car, get an auto insurance policy. Buy a home, get a homeowners policy. But for those who practice the Muslim faith, insurance is not so simple—they must find insurance that fits within an Islamic framework. In other words, it must comply with Shari'ah, the body of Islamic religious law. It is unlawful for Muslims to participate in conventional insurance due to several key components: interest which includes speculation and possible usury, and uncertainty, which is akin to gambling and includes unacceptable risks.

Takaful, the Islamic alternative for insurance coverage, eliminates each of these concerns since it is based on the concept of mutual indemnification. The basic elements of takaful insurance include mutual guarantee, fund ownership, lack of uncertainty, and Shari'ah-compliant management and investment—participants are essentially both insurer and insured.

Similar to cooperative insurance, members (Muslim or otherwise) contribute to a pool of funds which are used to indemnify participants who suffer a loss. At the end of the year, shortfalls are covered with interest free loans by the

company and paid back by policyholder donations, or premiums. When there are surplus funds, they are distributed back to policyholders.

Not a New Concept

While largely an unfamiliar term in much of the U.S. and Canadian markets, takaful is not a new concept. In *Takaful Islamic Insurance: Concepts and Regulatory Issues*, the author notes that the

QUICK LOOK

- Demand is burgeoning for commercial and personal insurance that fits with the precepts of Islamic law.
- Takaful, a style of insurance that abides by Shari'ah, is increasingly being offered by mainstream insurers.
- The U.S. market is in its infancy.

first modern takaful insurance came about in 1979 as a Sudanese Shari'ah scholar attempted to solve a juristic problem, "How may the Shari'ah prohibition of trading in insurance (and in indemnities and guarantees more generally) be overcome?" In answer to the question, the world's first takaful company was created by the Faisal Islamic Bank of Sudan, followed that year by the Arab Islamic Insurance Company in Dubai. In 1984 the Malaysian Takaful Act went into effect, and Takaful Malaysia was established.

Since then, takaful has seen much of its growth in countries with high Muslim populations including Saudi Arabia, Bahrain, Pakistan and Indonesia. Though currently underpenetrated, few disagree as to the potential market share that exists, even in countries with a lower percentage of Muslim citizens such as the United States.

Growing Population and Opportunity

Population statistics for the total number of Muslims and any growth data vary widely, but most show an increase. Contributing to the increase is higher birthrates, conversion and, some suggest, the willingness of Muslims to identify themselves as such. The Muslim population in Britain alone has grown by more than 500,000 to 2.4 million in just four years, according to research conducted for U.K.-based *The Times*.

As the community increases, so does its buying power. A recent report by HSBC, which established its global Islamic financial services division in 1998, estimated the size of the global Islamic banking market to be between

FIGURE 1
Conventional forms of insurance are prohibited under Islamic law as they contain elements of *Maysir*, *Gharar* and *Riba*

	Takaful	Cooperative Insurance	Proprietary Insurance
CONTRACTS UTILIZED	Donations and mutual contract.	Mutual contract.	Exchange contract.
COMPANY RESPONSIBILITY	Pay claims with underwriting fund; interest free loans in case of shortfall.	Pay claims and underwriting fund.	Pay claims from underwriting fund and shareholder's equity.
PARTICIPANTS' RESPONSIBILITY	Pay contributions.	Pay contributions.	Pay premiums.
CAPITAL UTILIZED	Participants' fund.	Participating capital.	Share capital.
INVESTMENT CONSIDERATIONS	Shari'ah compliant.	No restrictions except prudential.	No restrictions except prudential.

Source: Ernst & Young 2009 World Takaful Report

\$650-750 billion a year and said it was rising at more than 15% a year.

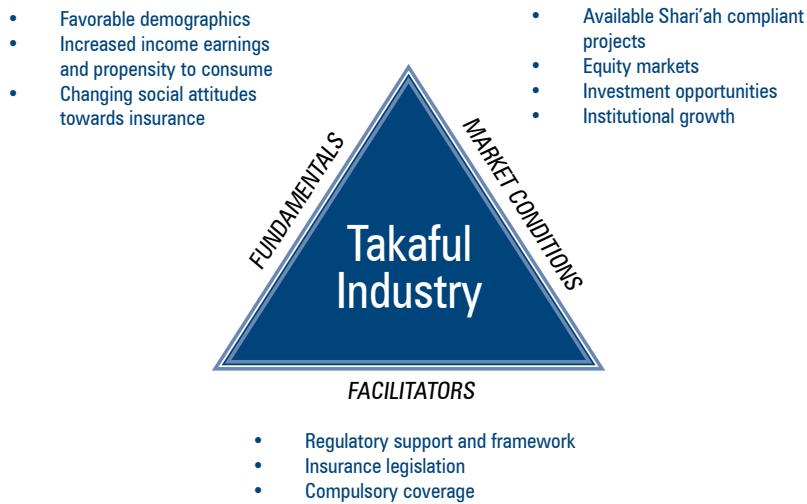
Reuters recently quoted Saleh Malaikah, chairman of Islamic reinsurance operator BEST Re, who stated that takaful business was expected to grow 17% a year over the next three years, after annual growth of 25% from 2004 to 2007. "With a quarter of the population around the world belonging to the Muslim faith, there is a great potential for the takaful industry to grow,"

Malaikah said to an industry conference in Singapore. Ernst & Young estimates that the global takaful market could reach as high as \$8 billion by 2012.

Some governments are stepping in to boost participation in takaful insurance. In an August 2009 article in *The Actuary*, Ashan Jamal gave a snapshot of the increased acceptance of takaful in Pakistan. "Almost 97% of Pakistan's population is Muslim, and the reason behind the low insurance penetra-

tion rate in this country is that insurance is regarded as unethical (haram) from a religious point of view by a large segment of people," said Jamal. "Therefore, the government of Pakistan has been actively involved in promoting [takaful] over the last few years. The [Securities and Exchange Commission of Pakistan] introduced takaful rules in 2005 to regulate operations of takaful insurance companies; the act also allows conventional insurance

FIGURE 2
Long term growth of takaful is predicted on strong underlying factors



Source: Ernst & Young 2009 World Takaful Report

companies to transform into takaful-based companies. Initially, Pakistan was slow to respond to the global takaful trend, but, within a brief period, five takaful companies (two general and three family) were established, and more companies are scheduled to enter the market in the near future. Foreign investors, particularly from Gulf countries, are heavily investing in Pakistan's takaful industry."

Education and Confidence

The biggest challenge to penetrating the Muslim community worldwide is education, according to Dr. Karen Hunt-Ahmed, assistant professor of finance at DePaul University. "People are skeptical because of the element of speculation. First, it helps if the customer is educated on why it is important to have insurance in the first place, that it is more of a risk, or gamble, not to participate," said Hunt-Ahmed. "Second, takaful companies must reassure participants and demonstrate compliance. One of the primary concerns is that they are investing donations in compliant ways."

Assurance in compliance with Shari'ah is a critical factor for Islamic insurance companies. In 2006, AIG began to offer takaful property and casualty products through AIG Takaful Enaya in Bahrain. Due to the unique nature of these offerings, they maintain a Shari'ah board consisting of Islamic scholars. There are few such scholars in the world, but they are elemental for a company's standing. For Islamic insurance companies, their Shari'ah board reviews operations and

supervises the development of new offerings in order to maintain strict compliance with Islamic law for all products and investments.

"The ability of a company to set itself up to be compliant and have a reputable Shari'ah board is the most important characteristic in building confidence for participants," says Hunt-Ahmed.

Confidence in Investment

While experts debate over the need for takaful in the first place, one area where there is little dispute is that conventional insurance companies invest policyholder funds in interest-bearing assets—something strictly forbidden and not Shari'ah compliant. In response, participant donations are not to be invested in banks or other companies that earn profits through interest. There are acceptable options, but non-interest investments are required, which also makes it difficult for takaful companies to start from scratch without money from a conventional source. "Ideally, companies would be completely separate," says Hunt-Ahmed. "If there are concerns with the comingling of funds, companies make the effort to purify them by donating a portion to charities. People are fairly comfortable with this practice."

Not So Easy

Though growth is increasing, prudence is warranted. The solution must satisfy the complexities of corporate governance (mutual and cooperative) regarding share capital, and it must meet regulatory capital adequacy and solvency requirements. Hybrid solutions have been created to address the conundrum of a company

Terminology for Understanding Takaful Insurance

Takaful – the Islamic word for solidarity and an Islamic insurance concept which is grounded in Islamic banking transactions

Shari'ah – law based on Islamic religious teachings

Participant – the insured, or policyholder, who takes protection against a named peril

Contributions – donations or premiums

Operator – the company that invests the capital (shareholder) and manages the operations in a takaful company

Gharar – risk, hazard or extreme uncertainty tied to critical components of an agreement

Haram – prohibited elements in Islam according to Shari'ah

Riba – usury, interest

Maysir – gambling or speculation

where the equity belongs to the shareholder in some cases being managed by a company with traditional shareholders. Challenges presented by this complex structure raise myriad unanswered questions for insurance regulators.

Development of international prudential standards has been intricate in this area. Two organizations in particular stand out—The Islamic Financial Services Board (IFSB), which has made three exposure drafts available, including *Guiding Principles on Governance for Islamic Insurance (Takâful) Operations*, and The International Association of Insurance Supervisors (IAIS) which has published documents on core principles and other relevant key topics.

In the United States, takaful lines oversight and rate setting aren't—and won't likely soon be—contained under a centralized takaful

authority since surplus lines insurers are regulated by their state of domicile. Parcelling out regulation based on a specialty line, such as takaful, isn't in the script. In fact, AIG, in partnership with Lexington Insurance Company, a surplus lines insurer, is the first company to offer takaful products in the United States. It is regulated wholly at the state level, and changes foreseen in any federal office of insurance regulation haven't even touched on managing the sales or governance of takaful (at least publicly).

With the U.S. market penetration underway, claims professionals would be wise to gain an understanding of the unique challenges presented by this type of insurance well before it comes their way. **CA**

Bevlee J. Lips is publisher and editor in chief of Claims Advisor.