Risk culture and sharing of surpluses for Takaful operators

TAKAFUL & RE-TAKAFUL (EUROPE)

By Ezzedine Ghlamallah

In the context of risk management, a Takaful operator is faced with challenges in defining, identifying, measuring, selecting, fixing prices and mitigating risks between asset classes in participants' risk fund as well its risk exposures. The management of these risk exposures is an ongoing process which must be carried out in the implementation of the company's strategy and which must allow an appropriate understanding not only of the nature and the importance of the risks to which the company is exposed, but also the rules and principles of the Fiqh to which the Takaful operators and the Takaful participants are contractually bound.

Thus, Takaful operators must adopt a solid risk management framework to protect the interests of participants and shareholders. The establishment of a risk culture for Takaful companies should not be overlooked, and the supervision of the board of directors represents a key factor in achieving this aspiration. The evolution of Takaful regulations in several markets and the expansion of the universe of investments in accordance with Shariah, in particular Sukuk, have a positive impact on the development of the industry because, without Sukuk, it is difficult for a Takaful company to manage investment risks.

One of the biggest problems facing the Takaful industry in particular and the Islamic financial industry in general is liquidity. There is a lack of Shariah compliant assets that are liquid enough. This inhibits and restricts innovation in the Takaful industry due to lower yields as well as liquidity risk and ultimately limits the growth of the sector. As soon as short-term Sukuk become available, they are immediately taken over by Islamic banks, which leave little or nothing to Takaful operators, while long-term Sukuk involve liquidity problems.

One solution could be, as many practitioners have suggested, that Takaful companies outsource their investment responsibilities to management companies who will use their skills and knowledge to obtain better returns from managed funds. Indeed, the financial performance of Takaful companies in the Middle East has been closely correlated with the performance of stocks on the local stock market due to the predominance of equity investments in the portfolios of Takaful institutions. This is harmful, as the resulting volatility can have a detrimental effect on the solvency of Takaful funds. The IFSB, therefore, states that the implementation of its standards will result in a robust and vigorous Takaful system on a global scale.

The question of sharing surpluses is also a central subject. Some scholars, like Lukman Olorogun from the Higher Colleges of Technology in Abu Dhabi, the UAE, aim to consider a general model which allows the return of excess subscription payments to participants. The goal of this model is to create a fair means of calculating premiums that maximizes the ownership of the Takaful fund.

Another scholar, Hayat Khan from La Trobe University in Melbourne, Australia, analyzed the power of incentives offered to Takaful operators to alleviate the problems associated with such a relationship between participants and the Takaful operator which is essentially a principal–agent relationship.

Emphasis is placed on the efficient functioning of the insurance market for all stakeholders. The incentives include so-called Wakalah commissions, initial agency commission as a percentage of contributions paid, so-called Mudarabah commissions which represent a share of investment income from technical reserves, and the sharing of surpluses (a share of excess insurance). Hayat's research concluded that all the incentives offered to Takaful operators must include the sharing of surpluses. A Wakalah–Mudarabah hybrid model is also recommended as it encourages the operator to increase the size of the fund, which in turn reduces the average risk to the benefit of participants.

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