Way to grow

THERE IS PLENTY OF GOOD NEWS FOR THE ISLAMIC INSURANCE SECTOR IN THE LATEST WORLD TAKAFUL REPORT, AS **PETER WILLIAMS** DISCOVERS.

The world takaful market grew 19% to reach US$8.3bn in 2010, according to Ernst & Young's latest annual survey of the Islamic insurance sector. While this was a rate of growth slower than in previous years, it still hit double digits. What's more, in the key markets of Malaysia and the UAE it grew by over 24%, while in Saudi Arabia the industry took in US$0.5bn more than the year before.

The challenge remains the maintenance of profitable growth in the dour economic climate and to some extent the sector has been successful. In the Gulf Cooperation Council (GCC), for instance, more takaful businesses reported a profit than in previous years, while the Saudi takaful co-operatives continued to grow although they still struggled to generate shareholder returns.

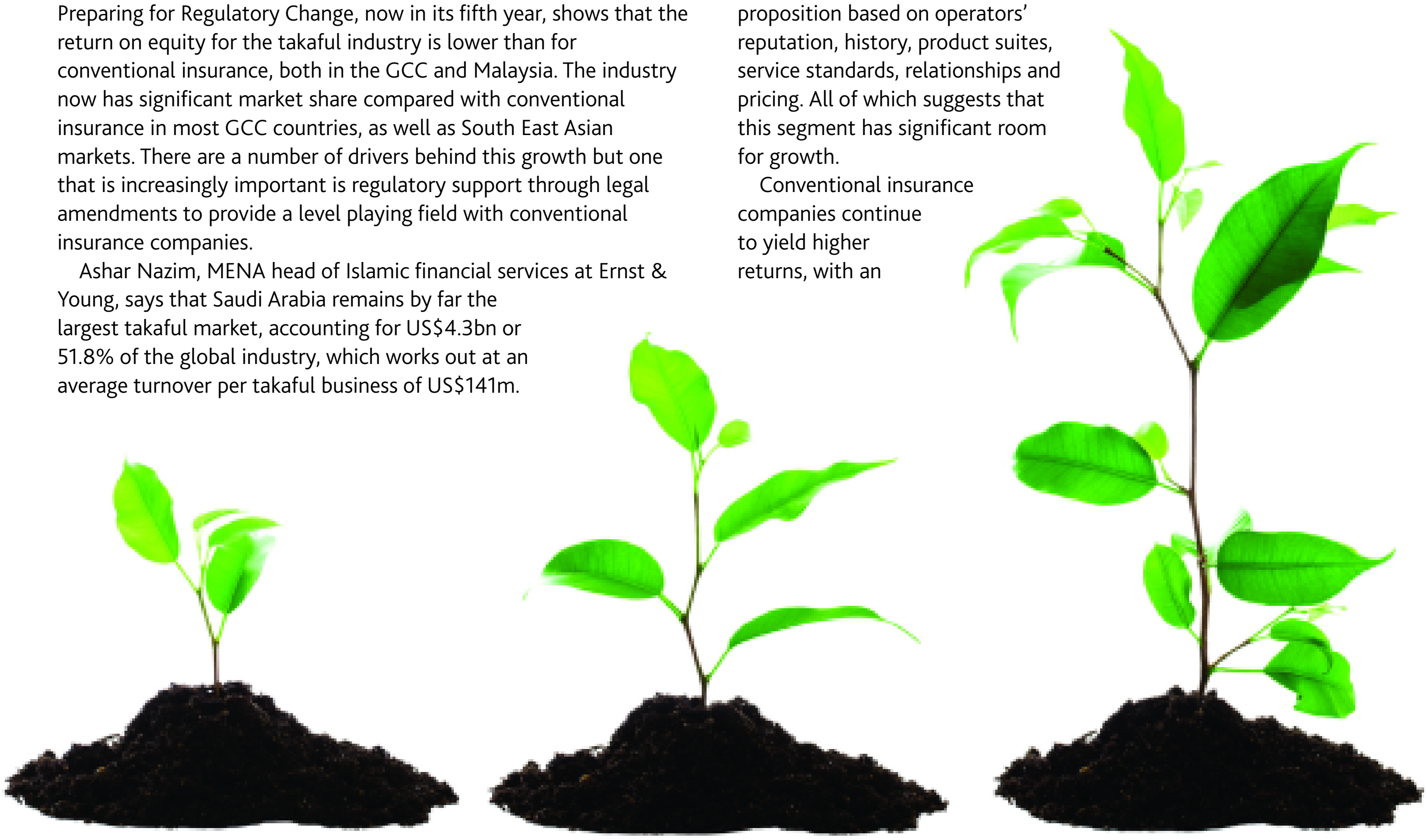
Ernst & Young's World Takaful Report 2012: Industry Growth and Preparing for Regulatory Change, now in its fifth year, shows that the return on equity for the takaful industry is lower than for conventional insurance, both in the GCC and Malaysia. The industry now has significant market share compared with conventional insurance in most GCC countries, as well as South East Asian markets. There are a number of drivers behind this growth but one that is increasingly important is regulatory support through legal amendments to provide a level playing field with conventional insurance companies.

Ashar Nazim, MENA head of Islamic financial services at Ernst & Young, says that Saudi Arabia remains by far the largest takaful market, accounting for US$4.3bn or 51.8% of the global industry, which works out at an average turnover per takaful business of US$141m.

Malaysia's 24% increase boosted total sector turnover to $1.4bn, again representing an average per business of US$141m (see Figure 1). The UAE came third with an US$818m market, growing at 28%. Sudan is the most significant market outside the GCC, and South East Asia had a market worth US$363m, although growth was only 7%. If emerging markets such as Indonesia and Bangladesh are included, Nazim says that gross global takaful turnover could be expected to touch US$12bn this year.

Islamic finance represents 25% of the total finance market in the GCC and 22% in Malaysia; the takaful share of the insurance market in these locations is 15% and 10% respectively. This suggests that the potential for takaful has not yet been fully tapped. Nazim says the Shari'a appeal of takaful makes it predominantly retail-driven in most markets. However, corporates should be attracted by the value proposition based on operators' reputation, history, product suites, service standards, relationships and pricing. All of which suggests that this segment has significant room for growth.

Conventional insurance companies continue to yield higher returns, with an



Regional reports

THE WORLD TAKAFUL REPORT IDENTIFIES A NUMBER OF POLITICAL AND ECONOMIC EVENTS AROUND THE GLOBE THAT ARE IMPACTING THE INDUSTRY.

EUROPE The European crisis has dampened the prospects of takaful making gains in the European market. Increased solvency requirements add to the difficulty given takaful's risk structures and the favourable treatment of debt instruments in the capital adequacy calculation. The appetite of European insurers to invest overseas may also be diminished as the new rules apply at a group level, as well as an insurer level.

MIDDLE EAST AND NORTH AFRICA (MENA) The Arab Spring has hurt the attractiveness of populous Muslim markets such as Sudan and Tunisia for foreign investments. Other countries such as Libya and Egypt were considered to be high-potential growth markets but projects have been postponed or affected due to the prevailing situation in these countries.

- **Saudi Arabia**. The Saudi Arabian Monetary Authority directed all takaful businesses to align themselves with the co-operative insurance model by the 2011 year-end. Takaful operators had to adjust their internal accounting structures, remove the use of wakala and qard, and amend product terms and conditions. Saudi is a huge takaful market and its shift away from the pure takaful model may have a variety of consequences for the industry, which is already in need of regulatory harmonisation.
- **Sudan and South Sudan**. Sudan is the largest takaful market outside the GCC and Malaysia. In July 2011 South Sudan seceded from what was till then the largest country in the world by area following a plebiscite, and the oil-rich but underdeveloped new independent state does not support Islamic finance and takaful. By contrast Sudan permits only Islamic finance and takaful. The partition between Sudan and South Sudan has resulted in a steep drop in the former's GDP growth due to the loss of oil revenues. Overall slowdown of the economy and reduced foreign direct investment (FDI) will directly impact the growth of the financial sector, including takaful.

SOUTH EAST ASIA Indonesia is emerging as a significant takaful market, overtaking several of the GCC countries in terms of gross written contributions (GWC) received by takaful businesses. South East Asia, including the important markets of Malaysia and Brunei, accounts for US$2bn in total GWC. The report suggests that with Saudi regulators disallowing the pure takaful model, the primary hub for the takaful industry may well shift from the GCC to South East Asia.

Figure 1: Global gross takaful contributions (US$m)

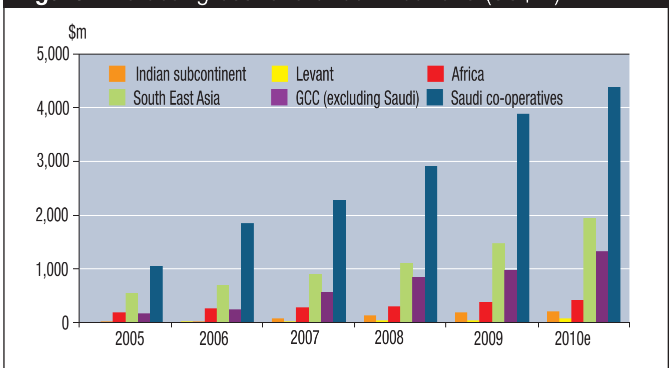
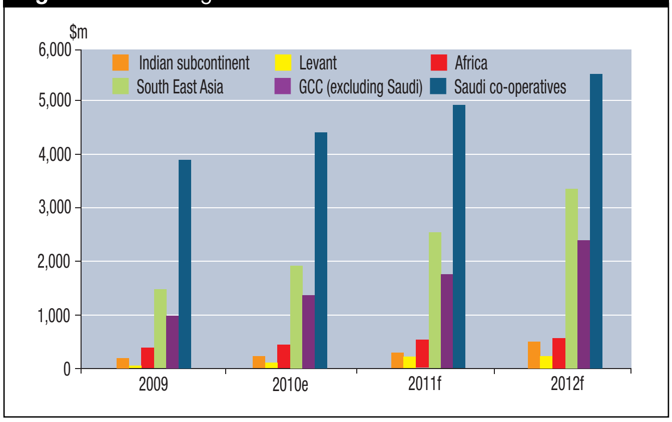


Figure 2: Global gross takaful contributions forecast



average return on equity of 8% in the GCC, compared with the takaful businesses' return of just 4%. Nazim says takaful operators in Saudi Arabia have struggled to show positive returns since the financial crisis. The local market is dominated by three players, with the rest having incurred high expense and loss ratios in their effort to gain market share. Takaful operators in Malaysia have better operating ratios than their conventional peers, while the reverse is true for the GCC.

Among the risks confronting the takaful sector in the GCC and South East Asia are strong competition, evolving regulations and a shortage of takaful expertise. According to the World Takaful Report, "young takaful operators are relying on aggressive strategies to compete against the established, older, conventional players. Such pricing is not sustainable and causing significant pressure on the industry's profitability. There are increasingly stringent regulatory requirements on capital and solvency, indicating the regulators' desired future direction."

The report suggests that most takaful businesses agree that the new regulations are a positive development but are concerned about growing regulatory variances between jurisdictions. Such variances make it difficult for takaful operators to function across regions, and lead to confusion for customers and multinational insurers.

Continued steady growth in core markets and the emergence of new fringe markets such as Indonesia, Brunei and Bangladesh suggest that the industry will have a value of US$12bn by the end of 2012, according to the authors of the World Takaful Report (see Figure 2). The forecast is based on respective growth rates in 2010 adjusted for emerging trends. The 2011 report forecast that total turnover would reach US$9.1bn by 2011. The results have been lower at US$8.3bn due to an unexpected industry slowdown in core markets relative to the high growth rates seen in previous years. Current growth rates would suggest US$12bn in gross turnover by the end of this year (excluding the Saudi market); total takaful turnover is expected to reach US$7bn by the end of 2012.

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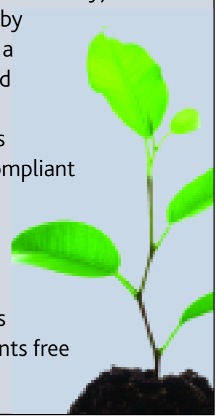
Explainer: takaful

Takaful is the Sharia-compliant alternative to conventional insurance. A conventional insurance company accepts premiums to cover claims and produce a profit. This activity is regarded as maysir (speculation), which is forbidden under Islamic law (Shariah). The payment of premiums in return for an indemnity against risks that may not occur is also seen as akin to gharar (uncertainty) under Islamic law and therefore forbidden.

Takaful is based on the concept of social solidarity, co-operation and mutual indemnification. While takaful insurance revolves around mutuality and has a non-commercial basis, the operations and fund are commonly managed by a takaful operator on a commercial basis. Takaful has the following five key elements:

- **Mutual guarantee**. The basic objective is to pay a defined loss from a defined fund.
- **Policyholder ownership of the fund**. Because they donate their contributions to the takaful fund, policyholders own it and are entitled, in general, to profits (different models vary).
- **Elimination of uncertainty**. This is achieved by donations to offer mutual help in the case of a policyholder's loss without any predetermined monetary benefit.
- **Sharia-compliant fund management**. This is achieved by the operator using two Sharia-compliant contracts, mudaraba or wakala, or a combination of the two.
- **Sharia-compliant investment**. All investments must be Sharia-compliant. Investment in haram (prohibited) industries is therefore eliminated and the use of instruments free of riba (usury) is required.

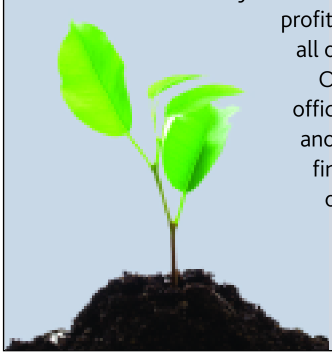


Building a takaful business

The strength of the players in the takaful market can be seen by the results of some individual operators. For instance, as we went to press, Abu Dhabi National Takaful Company reported profits for the year ending 31 March 2012 of AED6.1m compared with AED3.6m for the year ending 31 March 2011, a rise of 69.4%.

The business realised an underwriting profit of AED6.0m for the year ending 31 March 2012 compared with AED2.2m for the year ending 31 March 2011, an increase of 172.7%.

Company chairman Khadem Al Qubaisi said: "Building on the solid financial foundations that it has created in 2011, the company has managed to overcome the huge difficulties represented in the global financial downturn and the fierce competition in the insurance market to provide value for its shareholders and policyholders. We are delighted and proud of the excellent start to the year 2012, and we look forward to a year of profitable and sustainable growth across all of our business segments."



Osama Abdeen, chief executive officer, said: "I'm pleased to announce another set of significant and strong financial results for the first quarter of 2012 for Abu Dhabi National Takaful Company. This has been accomplished by implementing our strategy, which focuses on profitability, and by diversifying our portfolio mix and underwriting approach. In addition, we continue to place great focus on and invest in customer service and customer reach, which is evident from the opening of our new branch in Deira, Dubai, during the first quarter of 2012.

"Our shareholders and policyholders remain at the centre of our focus and attention as we progress by maximising their returns, which is evidenced by the 50% growth in basic and diluted earnings per share, which amounted to AED0.06 per share for the period ended 31 March 2012, compared with AED0.04 per share for the period ended 31 March 2011."

An alternative to conventional insurance, takaful is based on the concept of mutuality. The takaful company oversees a pool of funds contributed by all policyholders, but does not necessarily bear risk itself. In their investments, takaful operators must adhere to religious guidelines, including bans on interest and pure monetary speculation, and a prohibition on investing in industries such as alcohol and gambling.

Product categories are similar to conventional insurance, however, with family coverage, equivalent to life insurance, and general coverage, equivalent to property insurance, accounting for most business.

Despite the good showing of Abu Dhabi National Takaful Company, commentators suggest that the industry in general is slowing and there is increasing pressure on the sector to boost efficiency, roll out new products and explore new markets.