

Exploring family takaful's evolving landscape

As the appetite for family takaful grows, its underwriting principles and conventions are facing closer scrutiny.

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The fundamental aim of family takaful – the form of Islamic insurance closest to conventional life insurance – is to provide an underwriting platform so that contributors to its takaful funds can share responsibilities and cooperate mutually in order to safeguard one another from certain unavoidable risks.

Essence of takaful

The Arabic word 'takaful' translates as 'guaranteeing each other,' which is a fundamental concept of insurance. The Malaysian Takaful Act of 1984 states: 'Takaful means a scheme based on brotherhood, solidarity, and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose.'

At its root, takaful is a cooperative form of insurance. Operators share risk with participants – unlike conventional life insurance, which instead transfers risk from the insured to the insurer, and then to the reinsurer.

Takaful's principles can be summarised as follows:

- A takaful scheme is established for the common good of all participants.
- Participants aim to help one another in times of adversity, as adversity befalls all at one point or another. (This is the Islamic principle of *Ta'awun* – mutual assistance.)

- Charged contributions (which are equivalent to premium payments) are based on the Islamic concept of *Tabarru'* (donations given by free will). These donations are channeled to a fund that helps those who need assistance (eg, claimants). *Tabarru'* eliminates ambiguity in respect to payments to the operators and the amount of compensation for claims.
- If a takaful operator experiences losses, the losses should be shared as well, or claim payouts should be adjusted in accordance with what is affordable.
- No single participant in a takaful operation may gain at the expense of another.

Takaful underwriting and conventional underwriting

To be eligible to participate in a family takaful scheme, an individual or company must pass the takaful operator's underwriting requirements. Takaful underwriting is very similar to conventional underwriting, but it has some differences.

In both, underwriting is fundamentally a risk selection process. The underwriter uses information provided by or obtained from the applicant to evaluate the risk position, and then determines if the individual should be classified as a standard or an impaired (substandard) risk.



Family takaful underwriting must also test applicants for compliance with Shariah law. Accepted applicants' risk profiles must not include activities such as alcohol consumption, gambling, or undesirable lifestyles.

Underwriting paradox

Contributions charged by a family takaful operator must be commensurate with the underwriter's risk assessment. If the applicant turns out to be an impaired risk, family takaful operators can 'load,' or charge a higher contribution level from the applicant. Family takaful underwriting also permits the contract to be modified so that certain risks would be excluded, or coverage levels reduced.

So a paradox emerges: Underwriting, by its very nature, seeks to increase surplus and maximise shareholder return by keeping underwriting losses down. Because of this, underwriting protocols can be perceived as discriminatory, especially against those individuals classified as impaired risks, and therefore could compromise the major Shariah principles of *Ta'awun* and justice under which all takaful operators must do business.

Yet takaful operators are also required to manage risks prudently. Without proper underwriting, a family takaful operator could wind up being subject to adverse claims experience well above the projected average.

This has not happened yet – risk exposures for family takaful operators are still similar to those for conventional life insurers. But the unalterable paradox remains: life companies, whether conventional or takaful, still prefer to insure those with the least risk in their profiles, just as banks prefer to offer credit to those customers who need it least.

Walking the fine line between prudent underwriting and *Ta'awun*

How, then, can the family takaful industry implement the core concepts of *Ta'awun* (mutual assistance) and *Tabarru'* (gift or donation) in an equitable fashion for all, and yet still maintain solid, prudent underwriting principles while continuing to strengthen?

The use of international best practices in underwriting could spur future growth of the global takaful market. These practices could result in stronger, more economically efficient takaful operators, which could help lower contribution

rates, create and strengthen loss prevention techniques, and promote or enhance greater public acceptance of takaful.

Family takaful operators must always be sure that Shariah principles relating to equity and fairness are applied throughout the underwriting process. Family takaful's emphasis on underwriting 'pure' (non-speculative) risk is necessary to explain participant selection without denying the importance of mutual assistance, or *Ta'awun*.

Keeping surplus to strengthen operators

We would like to suggest that more family takaful operators consider not distributing the full underwriting surplus back to participants, and consider using a portion of what's retained to strengthen the operation.

For example, an operator could consider earmarking a portion of the retained surplus to be channelled to an Islamic Trust (*waqf*), in order to fund a secondary scheme to cover impaired risk applicants. Coverage can be modified to suit affordability for applicants to that secondary scheme.

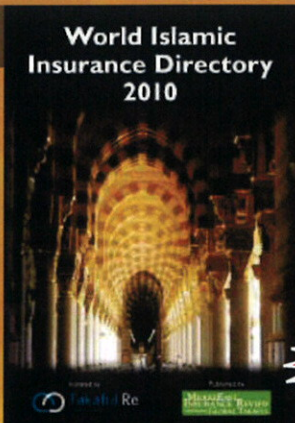
Establishing a claims stabilisation reserve could help family takaful operators remain resilient to adversity and volatility in claim experience, and also strengthen their regulatory capital reserves, especially given that Solvency II is requiring higher risk-based capital levels from insurers in order to cover potential business risks.

Greater risk-based capital strength, coupled with family takaful's Shariah-compliant investment restrictions that prohibit interest-driven and derivative instruments, could make family takaful products attractive to a non-Muslim market.

Khairat funds

Finally, family takaful operators might want to examine Khairat funds, which have long been used by Muslim communities in Malaysia to provide funeral benefits for participants. Participant affordability is not an issue, as these funds require only minimal contributions, and there are no restrictions imposed on any participants.

The Khairat concept could be extended by Takaful operators to include benefits for death, sickness, or accidental risk, which would help ensure that those covered under such a scheme could avoid the impoverishment due to risk exposure. ■



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