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Emerging Risks… Daring Solutions

Operational/Technical Issues in Takaful (Surplus Distribution, Solvency, Pricing, Deficit Funding, ROC).

Debo Ajayi, FSA, FCIA, MAAA

Managing Director & Actuary – Milliman LLC

UAE

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Operation/Technical Issues

- Conceptual
  - Objectives of Parties
  - Models
  - Unique Challenges
- Pricing
- Assets / Investments
- Reinsurance & Risk Management
- Reserving and Surplus Distribution
- Regulatory framework
- Solvency and Funding of Deficit (Qard-e-Hasan)

Conceptual Issues

- Linked to operational issues
  - Objectives of Parties
    - Shareholder / Takaful Operator : maximize profit and efficient deployment of capital
      - Sources of Profits:
        - Expense margins
        - Share of investment income, if allowed
        - Share of underwriting surplus, if allowed
      - Capital uses: Interest-free loans, Required Capital, Solvency Margins
    - Policyholder/Participant: Protection at net cost, Shariah Compliance, good value for money
      - Conventional products remain relevant benchmark

Conceptual Issues

- Models
  - Which model to use – Wakala, Mudarbah, Waqf, Hybrid
  - Each model has operational implications in terms of surplus distribution, product design, reserving, advertising etc
  - Accounting for models has to be implemented in light of Shariah, Accounting standards and actuarial issues
  - Takaful models can have significant impact on system requirements and level of customization
  - Presence of investment return sharing or "incentive fee" on underwriting surplus can have impact on investment policy and risk selection process

Conceptual Issues

- Unique Challenges
  - Operations and interplay between Risk Fund, Policyholder Investment, Qard-e-Hasan needs to be understood and implemented
  - Surplus Distribution mechanism
  - Family Takaful and General Takaful are similar but each has some specific issues due to duration of contract and structure of expenses compared to fees
  - Shariah board audits

Product Pricing

- Takaful has unique considerations
  - How to incorporate margins within the product
  - Expense assumptions and investment returns
  - Charging for cost of capital and qard-e-hasan
  - Ensuring inter-generational equity through pricing and surplus distribution?
  - Treatment of lapses under Life versus Non-Life
- Objective is to maximize Shareholder value while ensuring competitive policyholder values
- Issues on Family Takaful side compounded due to longer duration of the contract

Assets / Investments

- Availability of appropriate assets / investments
  - Shariah Perspective
  - Risk Management Perspective
  - Asset Liability Matching
- Investment management is often outsourced
- Shariah principles require no guarantees on asset and liability side
- Current available options impacts liability structures

Reinsurance and Risk Management

- Limited ReTakaful capacity available in the market – prevents companies to take bigger and more volatile risks
- Dispensation to cede to conventional reinsurers has implications on the "purity" of the concept
- Reinsurance structures limited –risk premium basis – other structures not utilized
- Use of derivatives even for hedging is generally prohibited

Reserving and Surplus Distribution

- Reserving is based on same actuarial principles
- Implications of Margins for Adverse Deviations
  - Must be reasonable for Pure Takaful
  - High margins=deferment of surplus
  - Lower margins=greater chance of deficiency
- Surplus determination is currently simplistic and raises many equity issues
- Surplus distribution requires robust administration and accounting system
- Surplus distribution broadly clear in concept, but lacks a lot of specifics

Regulatory Framework

- Distinct versus integrated Regulation
- Some allow conventional insurers to operate Takaful "windows"
- Some prescribe models
- Shariah Board is generally a requirement for Takaful operations – has additional corporate governance and cost implications

Solvency and Funding of Deficit (Qard-e-Hasan)

- Solvency is determined at shareholder's level
- The formulae / methodology for solvency calculation is normally same as for conventional insurers
- Rating agencies are trying to come up with rating structures for Takaful companies
- Funding of Deficit has to be done by Takaful operator
  - Interest Free
  - Superior claim to future surplus
  - Implication is to pass risk back to the shareholder / operator