Takaful

Financial Statement Review

Project Report

Group:

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Abstract

The rapid development of the market for the Takaful risk-protection mechanism in Arab and Asian insurance markets since 2004 is of potentially great regional importance. Islamic communities have always stood out as being materially underweight in insurance penetration, particularly for personal lines, both life and non-life, but Takaful appears to offer a genuine alternative to "traditional" insurance companies, both within the Islamic community and without. Takaful and Retakaful companies present themselves as offering Muslims an acceptable solution to risk management and prevention, which traditional insurance companies have been considered unable to offer.

The aim of the project is to analyze the financial statements of general Takaful companies, taking the annual report of Pak-Qatar General Takaful as the subject matter. The line items in the accounts of the company will be explored to evaluate their interpretation along with differences in disclosure that emerge because of the insurance business being conducted in a Shariah complaint manner, according to the Waqf-Waqala model. This will incorporate assessing what instruments the subject company invests in as well as the similarities and differences compared with regular insurance companies with regards to disclosure. In addition, we will be analyzing the various reserves created namely, Participant Takaful Fund (PTF) and the Shareholder Fund (SHF), their components and the treatment accorded to them in the financial statements.

Through this analysis, we hope to highlight the differences in disclosures as well as some individual line items that exist in the financial statements of Takaful companies as opposed to conventional insurance companies (with the financial statements of Adamjee Insurance Company as the subject matter). This may augment efforts in

meaningful relative evaluations conducted between Shariah compliant and conventional insurance companies.

Conventional Insurance and Takaful

Insurance is a product whereby the party that approaches the insurance company agrees to make regular agreed upon payments called "premiums" to the company in exchange for transferring the burden of uncertainty from specified financial losses to the insurance company. The fixed premium payment insures the client against potentially uncertain losses, resulting in mitigation of risk and better budgeting of expenditures. The insurance company collects these premiums from all clients, invests that money in extremely safe investments, such as government bonds, and keeps capital on hand to pay claims made by its clients. Thus the insurance company earns profits via any "underwriting surplus" (excess of total premium contributions less total indemnities paid in respect of claims net of reinsurance, expenses and changes in provisions) that is left over along with profits from investments. Conventional insurance is not deemed Shariah compliant due to the following factors:

- Riba Buyu': Money is the subject matter of insurance contract & exchange is in a manner whereby amounts of premium and claims vary & take place at different times.
- Gharar and Maysir: Exchange may not take place as the event giving rise to the claim may not occur.
- Investment in interest bearing fixed income securities is prohibited in Islam.

Takaful (Appendix B) is different from conventional insurance in that the client pays contributions to the Takaful operator on the basis of tabarru (donation with a condition of

compensation in case of loss) which becomes part of a broader fund of participants engaging in mutual cooperation for risk sharing. The Takaful operator does not act as a bearer of risk but just a trustee of the fund, investing in Shariah compliant securities and equity. This eliminates riba buyu, as a commitment to helping fellow participants and self becomes the subject matter of the contract instead of exchange of money for money. Concept of tabarru also eliminates gharrar and maysir from the contract. The Takaful company draws a fee or a share of investment profits depending on which model is followed while underwriting surplus is passed on to participants.

Waqf-Wakala Model of Pak-Qatar Takaful

In the model followed by Pak-Qatar Takaful Company (Appendix: A), two parallel funds are created called the Participants' Takaful fund (PTF)[1] and the Shareholders' fund (SHF). The Waqf fund in this case is a separate legal entity created by initial donation (Cede Money) from the Shareholders' Fund. The Takaful operator acts as wakeel of the fund, drawing fees of 30-35% of contributions for the service while participants make one-sided donations to the fund, whereby there is no obligation to pay back underwriting surplus though it is still returned in practice. Investments in Shariah compliant investment modes are undertaken by the Takaful operator, the income from which is shared on a pre-agreed basis between Takaful operator and participants according to mudarabah contract. Eventually, from the PTF, operational costs and reserves are taken out leading to distribution of the remaining surplus among participants. From the SHF, management expenses are subtracted and the remaining profit/loss is distributed to shareholders. In the

[1] A separate risk pool to which the participants' risk related contributions are paid to and from which risk related benefits are paid out.

case of deficiency in the fund where claims exceed assets, the SHF provides mandatory Qard-e-hasana[2] to the PTF which is paid back with a future surplus.

Differences in Balance Sheet

Considering the relative disclosures in the Balance Sheet of Pak Qatar Takaful and Adamjee Insurance, some notable differences are seen to exist. There is segregation of assets and liabilities of the SHF and PTF in Takaful, signifying the completely separate status of the Participants' Takaful Fund whereas no such segregation exists in Adamjee's Balance Sheet. This Segregation is necessary because it helps determine surplus or deficit which would impact the distribution to participants and because it aids in the determination of the solvency position of the takaful fund and, therefore, the possible determination of a need for Qard-e-Hasna or repayment via surplus. The PTF is also represented in the equity portion of the Takaful as opposed to a liability which also includes reserves via estimation for IBNR[3], Unearned Contributions and other similar ones which are comparable with equivalent provisions recognized in Adamjee's Balance Sheet. A difference thus arises as the latter forms part of liability of the company and is a charge to profit while reserve is an appropriation to the profit.

A notable change is recognition of a "contribution deficiency" reserve in Takaful balance sheet which is drawn from surplus to mitigate risks from deficiencies in the fund and to limit reliance on Qard-e-hasana to potential claims. An equivalent capital reserve exists in Adamjee's balance sheet disclosed in equity portion, but its purpose is to take

[2] Qard-e-Hasna.- When the PTF including reserves are insufficient to meet their current payments less receipts, the deficit is funded by way of an interest-free loan (Qard-e-Hasna) from the Shareholders.
[3] The Reserve for Claims Incurred But Not Reported (IBNR) pertains to the estimated cost of settling claims incurred but not reported at the balance sheet date on the basis of past trends and management's estimations.

advantage of tax benefits which are no longer available, as conventional insurance company has no need to account for Qard-e-hasana. Another portion of the PTF is "cede money". There is no such disclosure in conventional insurance as there is no need to start a fund for participants and disclose it separately, thus not requiring such injections to be recognized in financial statements. This is a requirement however in Takaful due to status of Waqf as separate legal entity.

Further differences in the balance sheet include recognition of "unearned Wakala fee" as a liability. Its equivalent in conventional insurance is the "premiums received in advance" liability. The former is a fee charged for being in trust of the Waqf fund and is thus a distinctive thing from a conceptual perspective. Furthermore, any liabilities for other party risk mitigating measures relate to re-insurance for Adamjee and re-takaful for Pak Qatar which essentially serve the same purpose but differ in the modes utilized for performing the tasks, being Shariah compliant in the case of the latter.

Differences in Investments Portion

Investment component of Takaful consists of Shareholders Fund (SHF) in addition to PTF. It is essential that investment components of PTF and SHF are not pooled together to form a common pool of investment. Otherwise, the Rab ul Maal - Modarib relationship between participants and Takaful operator would no longer hold and the Takaful operator would be liable for sharing of profits or losses arising out of investments rather than receiving proportion of profit only. Investment strategies also differ between the two companies apart from segregation between the funds. Takaful Rules 2005 in Pakistan require not more than 80% of the funds to be invested in Shariah compliant Government securities. Hence, Pak Qatar General's major investments from its Share Holders' Fund

(SHF) are in Sukuks issued by WAPDA, Karachi Shipyard and Engineering Works and Government of Pakistan Ijarah Sukuks. In addition, some investments in immovable property, like sukuks of Century Papers and Boards Mills[4] and Engro Chemicals Pakistan Limited have also been made. Takaful Operators can also invest in joint stock companies excluding companies that indulge in non-Shariah compliant activities[5] and investment decisions should not be based on speculations but on sound fundamental evaluation of a company. The Takaful operators can also invest in redeemable capital e.g. mutual funds. However, investments in only those funds are allowed that operate under Shariah principles and are approved by the Commission. Instruments available in this category include Musharika Certificates, Term Finance Certificates (TFCs), Participation Term Certificates (PTCs) and others. A Takaful operator can also strike arrangements with an Islamic bank to provide it with capital to finance Musharika, Murabaha, Ijarah, Salam and Istisna.

Conventional Insurers have none of the above mentioned restrictions and invest in a wide range of financial instruments. Adamjee Insurance, for instance, holds shares in sectors ranging from Investment Banks, Investment Companies, Security Companies to Textile, Cement and Oil and Gas Exploration. Other instruments include Term Finance Certificates, Mutual Fund Certificates and Fixed Income Investments such as Defense Savings Certificates.

All investments made by the Takaful fund are subject to scrutiny by the Shariah advisory board. Both the PTF and SHF have to be valued at agreed upon intervals and all unrealized gains and losses along with any dividend income received have to be

[4] Secured by way of mortgage of immovable property of the company and ranking of the hypothecation charge over the assets of respective expansion project to the extent of beneficial right of the certificate holders with 25% margin.

[5] Conventional banking, companies dealing in pork, tobacco, gambling and arms and ammunition etc

recognized based on their investment classes such as Held to maturity, Available for sale or Held for trading.

Differences in Income Statement

The first and foremost disclosure difference between the statements of Financial performance measuring profits and losses of the two companies is that a Takaful Company presents changes in the revenue account of the Participants Takaful Fund (PTF) and the Shareholder Fund (SHF) corresponding to the different pools in order to calculate the surplus/ (deficit) accruing to each. On the other hand, a conventional insurance company presents the entire amount of premiums from underwriting and investment income as revenue and all the claims as losses in a single Profit and Loss statement.

For Pak Qatar Takaful, inflows to the PTF include contributions by participants net of Wakala fees, net commissions along with claims and rebates received from retakaful operators, investment income from PTF Funds along with any proceeds from salvages and recoveries. This revenue is setoff against any reported claims and incurred but not reported (IBNR) claims, expenses directly related to settlement of claims such as surveyors' fees, etc and the Modarib's share of the investment income from the PTF. The net amount gives the surplus/(Deficit) in the PTF for the year. Changes in the Contribution Deficiency reserve and the Qard-e-Hasna repayment reserve are also taken through the revenue account.

For the Shareholder Fund, inflows are net of Wakala fee (Wakala fee deducted by the unearned Wakala Fee), the modarib's share of the investment income of the PTF and the investment income from the Shareholders Fund. All other management expenses

directly related to the Takaful operations, other General and administrative expenses are deducted against this revenue giving Takaful Operator's profit before taxation.

Differences in Statement of Changes in Equity

In this case as well, a primary difference between the two statements is that Pak-Qatar presents changes in its two equity accounts namely, the PTF and the SHF as compared to a single statement of changes in equity by Adamjee in which any Profit/(Loss) is added to /(deducted from) the Retained Earnings. In Pak Qatar's case any surplus/(Deficit) in the revenue accounts of the PTF and the SHF are added to/(Deducted from) their respective accounts.

The PTF consists of various reserves, which in conventional insurance are classified as liabilities and treated as provisions. The Reserve for Claims Incurred but Not Reported (IBNR) pertains to the estimated cost of settling such claims at the balance sheet date on the basis of past trends and management's estimations. The Reserve for unearned contribution is the unearned portion of contribution income is set aside as a reserve. The Shareholder Fund, similar to the owner's equity account in the conventional model, consists of capital contributed by the stakeholders'. Both accounts also house the accumulated Surpluses/Deficits to date as well.

Qard-e-Hasana Treatment

With regards to Qard-e-Hasana, it is not appropriate to treat the amount outstanding as a liability of the Takaful fund and an asset of the Takaful operator. From a point of view of determining the extent to which the Qard is receivable by the Takaful operator, it is clear that this is contingent upon future surpluses arising in the Takaful fund. In accordance

with the prudence concept, therefore, this should not be recognized as an asset. As a corollary, therefore, the Qard should not be recognized as a liability in the Takaful fund. Experts in the field support appropriation of profits in the P&L Account of the Takaful Operator and a capital transfer in the accounts of the Takaful fund. The capital available should be reduced by the amount of any Qard-e-hasana outstanding, as effectively, either treatment would reduce shareholders' equity.

Conclusion:

A good way to evaluate and analyze the differences between two business models is to evaluate the differences in accounting and disclosure requirements between the two paradigms. Hence, analyzing the financial statements and relevant disclosures of Pak-Qatar General Takaful limited and Adamjee Insurance Company Limited provide us valuable insights into their business models. Differing accounting treatments, classifications of line items and purpose of reserves and provisions emphasize the difference between the Takaful Waqf-Wakala model of risk sharing and the conventional insurance model of a risk taker.

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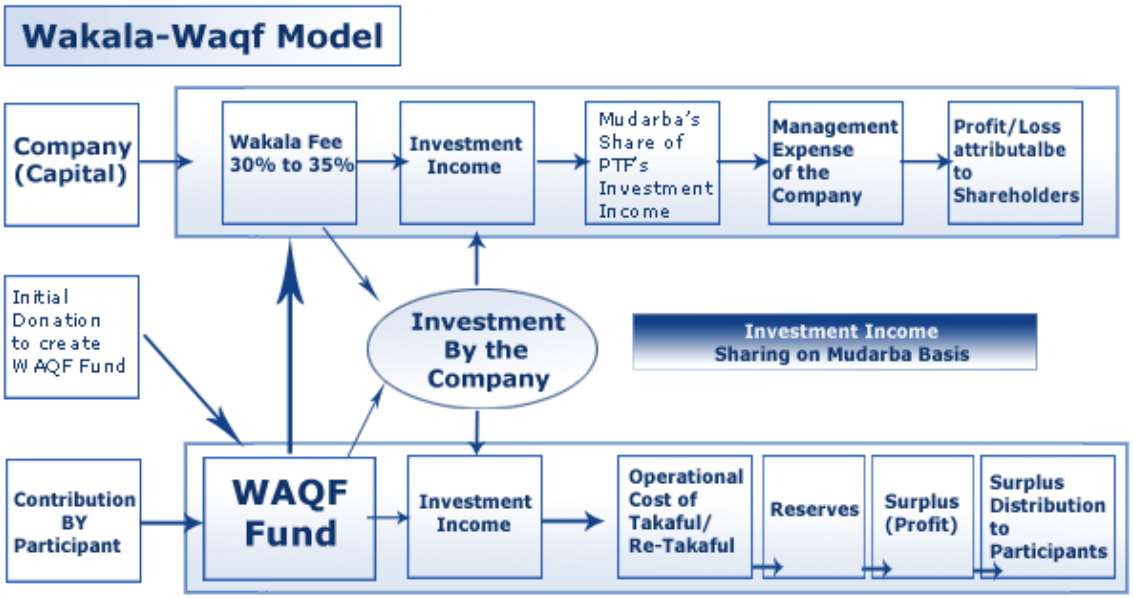
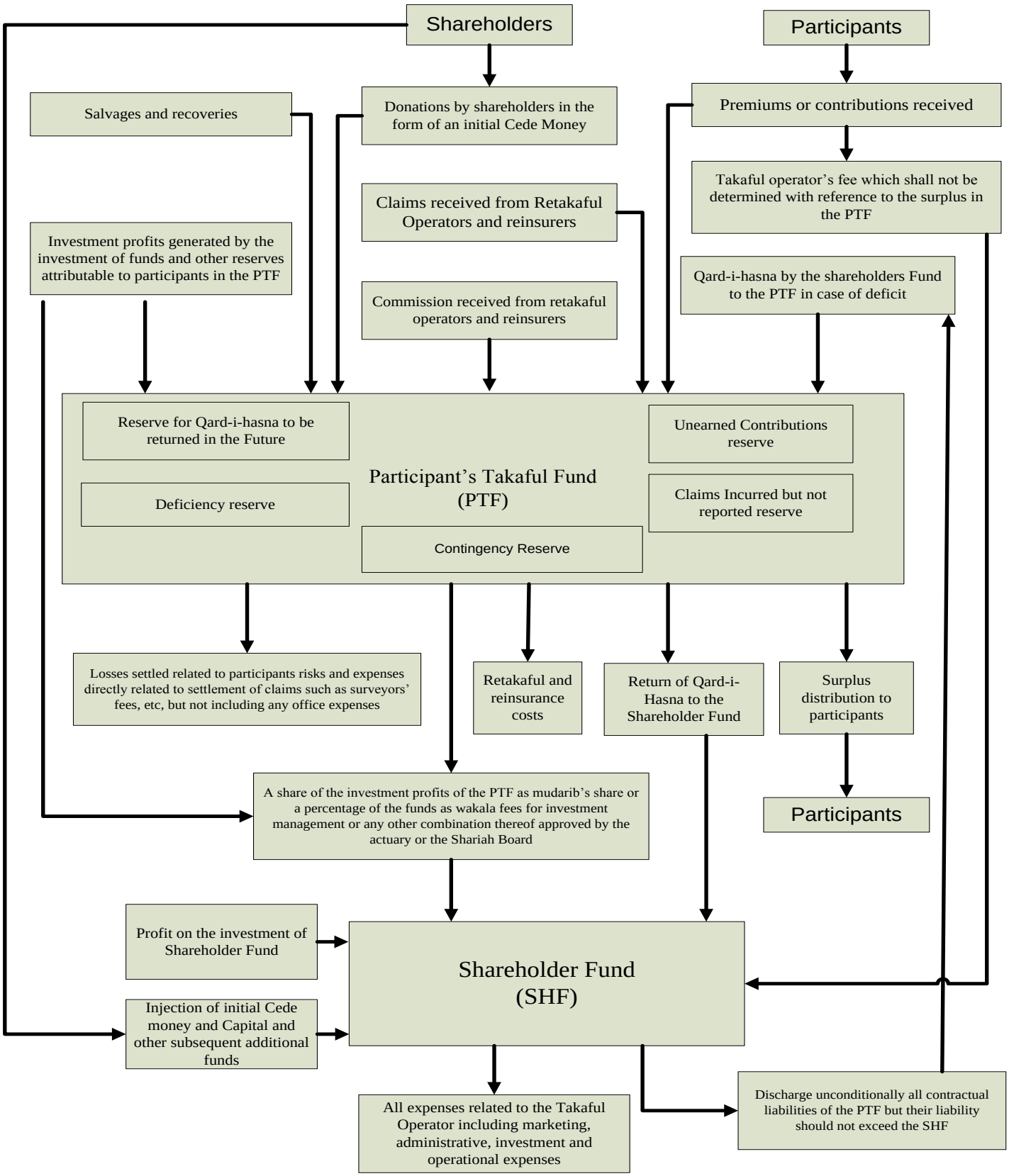
Appendix: A


Wakala-Waqf Model
Company (Capital)
Wakala Fee 30% to 35%
Investment Income
Mudarba's Share of PTF's Investment Income
Management Expense of the Company
Profit/Loss attributalbe to Shareholders
Initial Donation to create WAQF Fund
Investment By the Company
Investment Income Sharing on Mudarba Basis
Contribution BY Participant
WAQF Fund
Investment Income
Operational Cost of Takaful/ Re-Takaful
Reserves
Surplus (Profit)
Surplus Distribution to Participants

Appendix: B


Shareholders
Participants
Salvages and recoveries
Donations by shareholders in the form of an initial Cede Money
Premiums or contributions received
Takaful operator's fee which shall not be determined with reference to the surplus in the PTF
Claims received from Retakaful Operators and reinsurers
Investment profits generated by the investment of funds and other reserves attributable to participants in the PTF
Qard-i-hasna by the shareholders Fund to the PTF in case of deficit
Commission received from retakaful operators and reinsurers
Reserve for Qard-i-hasna to be returned in the Future
Unearned Contributions reserve
Participant's Takaful Fund (PTF)
Deficiency reserve
Claims Incurred but not reported reserve
Contingency Reserve
Losses settled related to participants risks and expenses directly related to settlement of claims such as surveyors' fees, etc, but not including any office expenses
Retakaful and reinsurance costs
Return of Qard-i-Hasna to the Shareholder Fund
Surplus distribution to participants
Participants
A share of the investment profits of the PTF as mudarib's share or a percentage of the funds as wakala fees for investment management or any other combination thereof approved by the actuary or the Shariah Board
Profit on the investment of Shareholder Fund
Shareholder Fund (SHF)
Injection of initial Cede money and Capital and other subsequent additional funds
All expenses related to the Takaful Operator including marketing, administrative, investment and operational expenses
Discharge unconditionally all contractual liabilities of the PTF but their liability should not exceed the SHF