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Financial Services

# Takaful

## A new global insurance growth opportunity

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Takaful is a form of insurance designed to provide life and non-life benefits to customers in a way that is compatible with the restrictions imposed by Islamic Shariah law – such as the prohibitions on Riba (interest) and Maysir (gambling). Despite these apparently complex restrictions, Takaful is already a successful product in several countries worldwide – Malaysia, in particular, is a focus of innovation and growth, and there has been significant interest in new ventures in the Middle East.

A great deal has recently been written about Takaful, much of it focusing on the how, not the why. In our view, however, there are some important strategic considerations to address before deciding on a Wakala or Mudharaba operating model. Takaful is not a small niche best dealt with by country operations in traditional Islamic geographies. Rather, it is a broad and exciting global growth opportunity, offering a way to capture a huge and currently underserved customer base inside the major Western markets – and with profit streams that, under a correctly designed model, could be more stable than in conventional insurance.

At Oliver Wyman, we believe that insurers who achieve success in Takaful will be those who:

- Focus on insurance potential, not just traditional Islamic countries
- Remember that Takaful can be attractive to non-Islamic consumers
- Treat the constraints imposed by Shariah law as opportunities not as deal-breakers
- Understand what competitive advantages they, and their competitors, bring to the table
- Take the next steps – soon

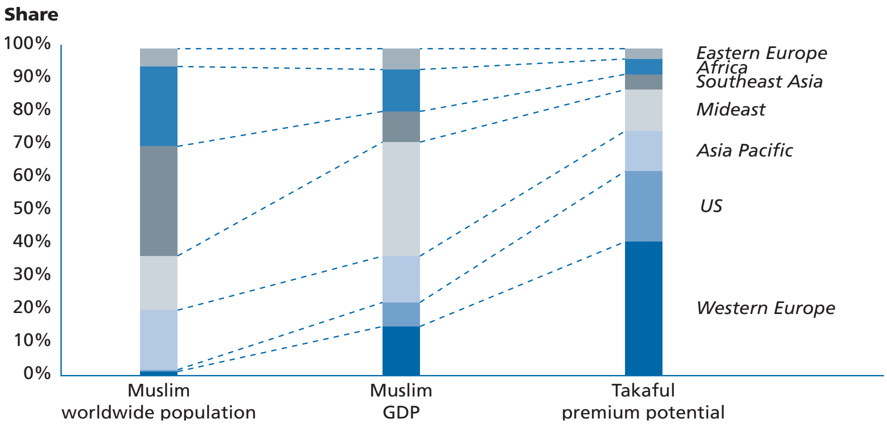
Those who ignore the Takaful opportunity, or who treat it as an uninteresting niche, are missing out on a revenue opportunity potentially worth more than $20 BN annually, more than half of which may come from the developed markets of Europe and North America, and perhaps 20% of which could be from non-Muslim customers.

# Focus on insurance potential, not just traditional Islamic countries

So far, the main focus of interest in Takaful has been in the Middle East, North Africa, and Southeast Asia. Malaysia, in particular, has seen significant activity, with nine composite Takaful companies already in the market, and several global competitors making moves in both the primary and re-Takaful[1] spaces. Similarly, there have been several moves by reinsurance players in both the Middle East and Malaysia.

These are clearly interesting markets, with large Muslim populations. But they are not the whole story for Takaful worldwide, and insurers interested in Takaful should not focus solely on these areas. If we consider not only the Islamic population, but also the wealth and propensity to buy insurance, then a rather different picture emerges. Western Europe, home to only 15 MM (or less than 1%) of the world's 1.6 billion Muslims, makes up 40% of the potential 'Muslim demand' today; adding the US brings the total up to 60%.

**Figure 1: Share of potential Muslim market by region**




**Source:** US State Department, Swiss Re, Oliver Wyman analysis

In terms of headline revenue potential, reasonable assumptions about likely penetration among Muslims, and adjustments for non-Muslim potential, suggest that there is worldwide Takaful premium potential of at least \$20 BN annually, compared to today's figures of \$4 BN at most.

This already provides a picture of potential demand that varies greatly from conventional wisdom. The implication is that cross-border insurance providers, in particular, should treat the Takaful

1 Shariah compliant reinsurance

opportunity as a global opportunity. Clearly, individual countries will face very different challenges. In our analysis, we consider three broad segments: the ‘existing’ Takaful countries such as Malaysia, embryonic Islamic markets such as the Middle East, and the developed markets in Western Europe and North America. Within these latter categories, we also need to consider country-specific attributes such as mono-culturalism versus multi-culturalism.

### Different challenges in various worldwide markets

| | Existing Takaful countries | Embryonic Islamic markets | Major developed markets |
|---|---|---|---|
| **Examples** | ■ Malaysia, Singapore | ■ Middle East, (e.g. Bahrain, Saudi Arabia, Turkey) | ■ W. Europe (e.g. Germany)<br>■ USA |
| **Muslims as % population** | Medium – low | High | Low |
| **Wealth levels (GDP/capita)** | Medium | Low – medium | High |
| **Typical insurance penetration (as % GDP)** | 5% | <1% | 8-12% |
| **Key challenges for insurers** | ■ ‘Building out the existing model’<br>– Getting foothold in ‘proven’ concept<br>– Growing insurance penetration<br>– Capturing share from existing insurers | ■ ‘Raising insurance penetration rates’<br>– Building insurance awareness in low-penetration markets | ■ ‘Capturing share with a new model’<br>– Getting pre-mium from already-insured Muslims and non-Muslims<br>– Some potential to increase penetration among non-insured Muslims |

Country differences notwithstanding, we see significant potential for global insurers to build scale advantages by constructing a model that can be applied across multiple geographies. Later in this paper, we will return to the question of what common elements could be used in such a model.

# Remember that Takaful can be attractive to non-Islamic consumers

The initial focus of any Takaful offer is, of course, the Muslim community. In general, Muslim communities worldwide are underserved with insurance products, particularly given the apparent Shariah restrictions on buying from conventional insurers. Accepted Shariah principles suggest that compulsory covers (such as motor insurance) may be purchased, if necessary, from non-Takaful providers, but generally discourage other purchases. Hence, in any given market with an Islamic population, there is market potential both from capturing insurance premiums currently with non-Takaful providers and from expanding the penetration of insurance products in the Muslim community. There is demand for Takaful across the whole range of insurance activities – from personal lines such as household and motor insurance; through long-term savings, life protection, and investment products; to insurance for corporate clients; and finally reinsurance (re-Takaful).

However, it is important to understand that Takaful does not need to be limited to the Muslim community. The distinctive features of the Takaful product – such as transparency over product profitability, an element of profit share, and the limitations on acceptable investments (e.g., no alcohol, no gambling) – may be attractive to the growing 'ethical investment' segment. Evidence from existing Takaful markets supports this – one Shariah-based investment-linked fund in Singapore has 50% non-Muslim participation, and the product has been notably successful even when marketed to an 85% non-Muslim population.

Similarly, in Malaysia, Takaful is popular amongst Muslims and non-Muslims. For example, over one-quarter of the policyholders in one of the Takaful operators in Malaysia are non-Muslim. With five new Takaful licences granted in the last six months, there has been massive provider interest – and the current (10%) share of the market taken by Takaful products looks likely to rise sharply. Among the new licensees were Prudential and HSBC from the UK and Tokyo Marine from Japan. They join Fortis, whose joint venture with MayBank has been successfully marketing Takaful products in Malaysia over the last five years.

Our analysis suggests that up to 20% of Takaful revenues could arise from non-Muslim customers.

# Treat the constraints imposed by Shariah law as opportunities, not as deal-breakers

Providers of Takaful insurance face some interesting product design, organisational, and risk management challenges, primarily due to the specific restrictions and requirements of Shariah law. However, we believe that meeting these challenges is less difficult than it might seem at first – and the insurers who deal effectively with them may be able to build scaleable, cost-efficient models.

## Product and organisational design

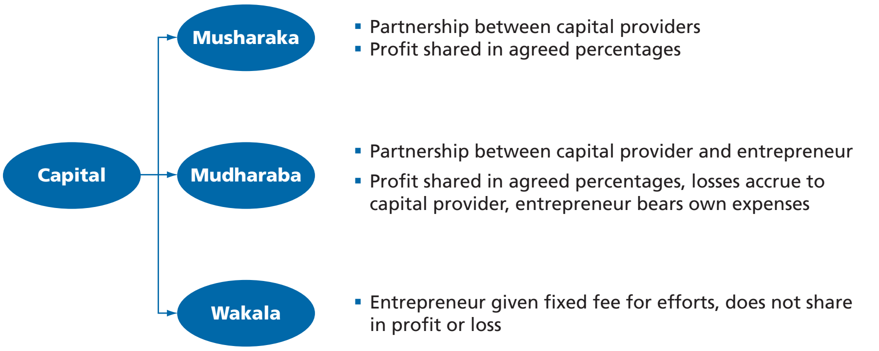
The most well-known restrictions from Islamic law are related to Riba (interest/usury), Gharar (uncertainty/sale of risk), and Maysir (gambling). Managing these requires some ingenuity.

The restrictions on interest (Riba) pose a direct challenge to typical investment and asset liability management strategies. The clear prohibition on profiting purely from 'renting' capital greatly limits the possibilities to invest even in standard government bonds – the selection of compliant Islamic instruments is as yet small. This will greatly complicate efforts to match long-duration liabilities with suitable matching investments.

The prohibitions on Gharar could, under the strictest interpretations, ban all forms of insurance – as for a given premium the insured passes on (sells) the risk to the insurer. However, this can be addressed by structuring the product in a co-operative manner, where premiums are treated as a contribution to the joint pool and operators are paid an agreed expense rate.

The primary Shariah concern is to ensure that the conventional contract of insurance is modified to a Shariah-accepted Contract of Compensation. Through the use of the appropriate contracts of compensation, the constraints outlined above can be satisfactorily resolved, for example, under the Wakala or Mudharaba model. Unfamiliar though the terminology may seem to new entrants, the underlying concepts are surprisingly similar to conventional structures in the market – indeed the Wakala fund structure is very reminiscent of the profit-sharing structures found within traditional 'participating/with profits insurance' seen in many European markets, such as Germany and the UK. As such, the challenges of managing and structuring a Takaful operation are real, but may not be as far from existing market practice as they might seem.

**Figure 2: Examples of Islamic contracts of compensation**




## Branding and distribution

Existing insurers will face some interesting challenges in marketing the product. From a branding standpoint, there are issues of overall brand credibility for the target community, and the question of positive or negative brand spillover for more traditional products – where will it be more useful to use a parent brand, and where a new brand?

Distribution is also key to reaching a specific target segment with a product that, at least initially, may appear relatively complex to the consumer. For the Muslim community, in particular, there may be ways to exploit affinity marketing techniques to generate interest in the product, and to generate interest both in switching existing products and in buying new products.

## Risk management and governance

There are important governance challenges in managing a Takaful business, not least of which is the need to appoint a Shariah Supervisory Board and then work out how to make this additional layer of governance function smoothly with the rest of the organisation and with the host country's insurance regulators.

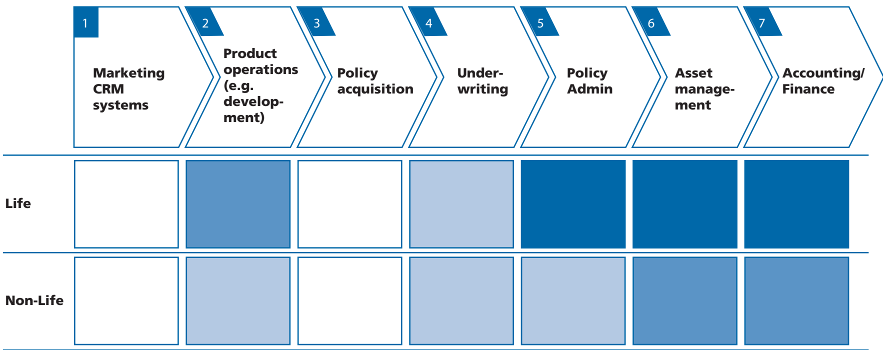
Moreover, within a co-operative fund structure, risk management is critical. Although policyholders are sharing the risk, the management company is required to finance any deficit in the co-operative fund, interest-free, should claims be larger than expected. Finally, reinsurance would ideally be via re-Takaful. Currently, there is limited acceptably rated capacity, and there is a temporary exemption allowing conventional reinsurance. We expect this exemption to be revoked once re-Takaful capacity grows, as is currently happening.

Within these restrictions, however, there are positive elements for the shareholders. For example, operator earnings may well be less volatile than for a conventional insurer as the policyholders are jointly sharing some of the risk. Also, the combination of additional capital commitment required to manage the ALM risks inherent in a Shariah-compliant investment strategy, limited re-Takaful capacity, and governance complexities increase the barriers to entry and increase the likely profitability for those players that are able to successfully implement Takaful models.

## Building scaleable models across geographies

Takaful brings a number of significant operational challenges and changes compared to conventional insurance models. For instance, policy management systems will need to be adapted significantly to cope with product design, investment management, and financial administration (e.g. tracking the policy-by-policy surplus share calculations).

**Figure 3: Indicative analysis – Relative complexity of conversion of conventional systems to Takaful**




The scale represents the difficulty of converting conventional systems, □ is least difficult ■ is most difficult

Source: Oliver Wyman analysis

By the same token, once these challenges are solved in one country, several aspects can be used elsewhere. Not all aspects can be ‘copy-pasted’ across countries – as there are clearly significant country-specific elements of detailed product design, marketing, and regulatory approval. However, there are also real and valuable commonalities, and we see this as an area in which insurers building a multi-geography business may be able to create competitive advantage through scale economies.

# Understand what competitive advantages you, and your competitors, bring to the table

As noted above, the main focus of worldwide competitive interest in Takaful has been a small number of markets, particularly in Malaysia and the Middle East – with several incumbents and several international insurers trying to enter.

Broadly, there are three types of insurer who are likely to enter the worldwide market for Takaful: existing single-country incumbents, new start-ups, and existing cross-border and global players. Each will have different competitive advantages:

- **Existing single-country incumbents,** who will benefit from an existing 'umbrella' brand name, but who may need to consider the branding impact of targeting a different customer segment with a distinct proposition; and who also will need to overcome the challenges in establishing a compliant operating model from scratch
- **New startups,** which may have some Takaful experience from backers who have existing Takaful operations in the Middle East or Southeast Asia, but will have little in-market experience in any given country; and will have an urgent need to develop end-consumer branding and channel relationships
- **Existing cross-border and global players**, whom we see as best placed to build a genuine cross-border business model, benefiting from incumbency positions in multiple markets worldwide and potentially able to design and exploit a scalable Takaful model; but who, at the same time, will need to determine how much of the Takaful model is truly common across different markets; and how a Takaful model should best be tailored to both market conditions and their particular brand positioning in each local market

It is too soon to know which of these types of insurer will prove most successful in the Takaful – if the history of insurance is anything to go by, most likely there will be success stories within each business model. However, whatever model is chosen, insurers wanting to succeed in Takaful will need to think carefully about how to build sustainable competitive advantage.

# Take the next steps – soon

The top-line growth potential for Takaful – arising from Muslims 'switching' out of non-Takaful products, new business from Muslims, and from the non-Muslim 'ethical' sector – is clear and has already been discussed. However, given the competitive nature of insurance markets, making bottom-line profits will depend on successfully addressing multiple elements of what is a new and different business model. New entrants will need to understand the demographics of the target segments; the organisational and risk management challenges (for example, in how to create a viable asset-liability management strategy); the cost implications of setting up a parallel fund and management infrastructure; and the potential for (and sustainability of) premium pricing.

These challenges are not trivial, especially in the highly competitive Western European and North American insurance markets. However, given the distinctive nature of the Takaful product and the innovative ways in which it can be structured and sold, there is definite profit potential for those insurers who can build a credible brand, structure the correct offer, create an appropriate organisational model, and learn from the existing successful competitors in worldwide markets. Indeed, Takaful offers a unique opportunity to access an untapped profit pool of Islamic and non-Islamic customers, across countries, in life and non-life insurance, and in both the primary and reinsurance markets.

But the time to act is now – competitors are waking up to the potential for Takaful, with new announcements almost weekly. Given the size of the prize and the strong first-mover advantage, the opportunities will not remain uncontested for long. Those who stake out the ground today could dominate this large and growing segment for many years to come.

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