The way forward for Takaful
Spotlight on growth, investment and regulation in key markets

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Content

Foreword	4
Executive summary	5
Maturing markets: case studies from the Middle East and South Asia	6
I. Economic and regulatory review – The growth equation	6
II. The insurance and Takaful industry – Trends and potential	8
III. Investment allocation trends – Analysis and insights	16
IV. Product versatility – Stressing innovation	17
V. Financial analysis of selected Takaful operators	18
Emerging niche market: Africa rising	28
I. Kenya	28
II. Nigeria	29
III. Tunisia	29
A third opinion: the prospects and future for Takaful	31
A practitioners' perspective	31

Foreword

Increasingly, many Takaful organizations are realizing the need to address the regulatory compliance and investment risks that threaten strategic objectives around growth and profitability. Equally, industry executives recognize the importance of implementing good governance practices to facilitate compliance and devise well-balanced investment strategies to realize growth and sustainability.

This report builds on our last study on the global Takaful insurance market, and looks more deeply into the core Takaful markets in the Middle East and South Asia. The analysis and discussion are formed around building case studies on those markets. The research team examined in brief the economic and regulatory environment in six selected countries, three from each region. The goal was to bring to our discussion, and to the readers, an update on developments on both regulatory and economic fronts.

A detailed analysis of the insurance sector and Takaful was made through cross-examining the financial performance and investment strategies for a selected group of prominent Takaful firms. The main business and economic drivers and factors underpinning the growth of Takaful business in those countries were discussed with analysis and rationalization.

This study marks the beginning of a new approach in the field of Islamic Finance which aims to promote a culture of industry-driven research

More importantly, this study marks the beginning of a new approach in the field of Islamic Finance which aims to promote a culture of industry-driven research. This aspiration was shared by Deloitte Middle East and two prominent research institutions – the International Centre for Education in Islamic Finance (INCEIF) and Henley Business School, University of Reading. As such, this study is a strategic collaborative research initiative aimed at promoting industry-sponsored research in Islamic Finance, and this report demonstrates the value of collaborative work and resource sharing to address practical and regulatory issues in our industry.

This industry research benefited from two important factors that added valuable inputs into the research process and implementation. The first is a group of student researchers at INCEIF who carried out the desk research and preliminary analysis of markets in South Asia – Dr. Mohd-Pisal Zainal, Alaa Alaabed, Irum Saba, Maznita Mokhtar, Layla Jawad, Adeelah Heesambee, Khurram Shahzad, and Fatema Hasan from Deloitte IFKC. The second is a sponsorship from FWU Group.

Finally, and as in our past thought leadership publications, the last section of 'Thought leaders' perspectives' invited and engaged prominent industry thought leaders and practitioners to share their insightful views on issues discussed. We are grateful for their valuable support in taking part in the debate and enriching the industry-wide dialogue to harmonize global industry practices.

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Executive summary

Generally speaking, insurance penetration rates in the markets examined in this study are invariably less than 5%, with the exception of Malaysia, Singapore, Japan and Hong Kong, where penetration rates amounted to 5.1%, 6.2%, 10.1% and 11.5% respectively.

Conversely, the global Takaful insurance market exhibited double digit growth, representing 18% Compound Annual Growth Rate (CAGR), during the period 2007-2012 with worldwide gross Takaful contributions reaching US$18.3 billion in the first half of 2013. Nonetheless, the size of the industry still remained fragmented and significantly small compared to global Islamic financial assets with a market share of 1.1%. These figures should not discourage the reader, and our industry study and analysis suggest that there are enormous growth prospects in the Middle East, South Asia and Africa.

The key emerging themes and findings of this study emphasize the need for harmonized or consistent regulatory frameworks, as below:

- There is a clear gap in the level of regulation and government support provided to Takaful and insurance firms. Malaysia is by far leading the wave of best practices legislation in the sector, and the Gulf Cooperation Council (GCC) is striving to improve playing field levels for both Takaful and insurance firms.
- There are increasing concerns among practitioners – in both markets – about over-regulation and the adverse effect of slowing product innovation, growth, and the ultimate dynamics and competitiveness of the industry.
- Health and motor insurance products dominate the GCC market, which is attributed to the mandatory regulation effect.
- In the GCC, the United Arab Emirates (UAE) has the best depth and breadth of products, and offers the most diversified suite of family and general Takaful products.
- Overall, the regulators in these markets are actively updating their insurance and Takaful rulebooks and codes of practice.

In the GCC, the United Arab Emirates (UAE) has the best depth and breadth of products, and offers the most diversified suite of family and general Takaful products

In terms of markets and practices, the study observes that Takaful product offerings and diversity of products are lacking, and that the Takaful business is by far underpenetrated in the six countries examined.

- Takaful penetration rates are very low in both regional markets under study, and Takaful players need to design crystal clear products and market strategies to reach mass markets.
- There is high growth potential in both markets, and in particular in Indonesia, Pakistan, Egypt, and the Kingdom of Saudi Arabia (KSA).
- GCC Takaful providers could leverage their proximity to rising opportunities in north and mainland Africa.
- Investment strategies lack well-balanced diversification, with firms in the GCC tending to invest largely in deposits, while in South Asia the strategy is focused on fixed income assets such as Sukuk.
- KSA’s firms have by far the most diversified investment strategies, and firms tend to invest in deposits, debt securities, and mutual funds.
- Bahrain’s insurers achieved relatively positive and stable returns on investment, while counterparts in KSA and UAE experienced volatile returns due to exposures in the troubled securities and real estate markets.
- Product offerings and diversity is led by firms from Malaysia, and these products are invariably replicated and introduced in the Middle East and GCC.
- In both markets, there seems to be an absence of strategic investment in human capital and professional development, a recurring concern noted by practitioners and policy-makers.

Maturing markets: case studies from the Middle East and South Asia

I. Economic and regulatory review – The growth equation

Strengthening the regulatory frameworks of the Takaful industry requires focused effort and the support of all industry stakeholders. National regulators as well as industry standard-setting bodies (SSBs) need to work together to take bold initiatives to improve Takaful practices and policy-making processes. More recently, Takaful and insurance authorities in each of the studied markets introduced new regulations which in the short-run might deter growth, but could change the structure, dynamics and competitiveness of the industry in the years to come.

Middle East

KSA

The consistent volatility of oil prices caused by regional geopolitical concerns has impacted KSA's real GDP growth, which went down from 5.1% in 2012 to as low as 3.6% in 2013. However, the upgrade of the country's credit rating outlook by Standard & Poor's (S&P) from "stable" to "positive" in the first half of 2013, was seen as a relief to market observers and helped to a favorable investment atmosphere to be created both internally by the government and externally in the form of Foreign Direct Investment (FDI).

Takaful and insurance authorities in each of the studied markets introduced new regulations which in the short-run might deter growth, but could change the structure, dynamics and competitiveness of the industry in the years to come

The considerable population growth of recent years has put pressure on the government to design and implement significant infrastructural and social projects. These investment projects, and financial and investment growth in KSA generally, received support from the Saudi Arabian Monetary Agency (SAMA) which continued to regularly introduce and update financial and banking legislation to support the country's strategic economic plans.

One relevant piece of legislation introduced by SAMA is that all insurance companies operating in KSA have to follow a cooperative business model that is seen to be slightly different from the widely-used Takaful model, but whose ultimate objective is to introduce a Sharia'-compliant business model for the insurance business. Another piece of legislation, arguably favorable to policyholders, is that insurance companies are also required to distribute 10% of net insurance surplus to policyholders directly or in the form of a reduction in premiums for the following year. The remaining 90% of the net surplus is transferred to the shareholders.

UAE

The recent global financial crisis seems to have impacted the UAE more than other GCC countries, largely due to its stronger economic ties with global financial and investment players. In addition, lower oil prices, financial market turbulence, and more specifically, other domestic factors such as the long-awaited considerable downward price correction in equity markets and real estate, have also played their role. But overall, the growth rates between 2008 and 2011 were only slightly lower than the pre-2007 era. This is largely attributed to the stronger shape of the country's sovereign wealth accumulated from the hydrocarbon industry. Between 2012 and 2014, the growth rate averaged 3.9% and forecasts for years ahead suggest growth rates above 5%.

On the regulatory side, the UAE's Insurance Authority has engaged an industry-wide discussion on solvency, financial reporting and investment practices, and consequently introduced new measures to enhance its regulatory framework including the existing Takaful Act.

This exercise was well-received by industry and market participants not only in the UAE but in the entire region, who welcomed the fact that market participants were able to share their concerns and pains in implementing regulation and support more practical ways to debate issues among insurance and Takaful players.

These newly introduced measures include preventing conventional insurance companies from offering Takaful products through window, and new corporate governance guidelines to ensure better Sharia'-compliance. In addition, the Insurance Authority introduced new stipulations to restrict the entry of foreign players into the insurance market. This protectionist strategy was met with mixed views: local Takaful operators think this will help growth in the limited market and will force smaller players to consolidate, while regional and international operators feel this will adversely impact on product development and desired business expansion.

Bahrain

In recent years, Bahrain's economy showed signs of improvement and achieved a growth rate of 4.8% in 2012 from 2.1% in 2011. This growth was attributed to the strong recovery in the non-oil sector, which accounted for 70% of GDP in 2012. The country also enjoyed a high population growth rate and became the fastest growing population in the GCC, with 18% cumulative growth in 2008-2011.

Building on its success, the Central Bank of Bahrain continued to provide strategic leadership in legislation enhancement and support to the Islamic Finance and Takaful community. The emphasis was largely concentrated in areas of practice and operational improvement such as surplus sharing, capital and solvency requirement, and Wakala fee. Regulatory changes have also forced some insurance firms to shift the emphasis to domestic insurance operations.

South Asia

Malaysia

Malaysia has the third largest economy in Asia with a population of 29.95 million, 61.3% of whom are Muslim. In 2008, the Malaysian economy was recognized by the World Bank for its recorded average growth of more than 7% per year over a span of 25 years. The country's GDP (PPP) was US$525.03 billion in FY 13, having increased by 4.4% from FY 12. While the country's sovereign rating (S&P) remains "A – Negative", inflation has risen to 107% due to the economy's robust growth. The government continues to encourage FDI, thus reducing poverty to 1.7% in 2012 down from 49.3% in 1970.

Malaysia's Takaful industry began in October 1982. Recently, the country has taken the regulatory landscape to a higher level with the new framework, after the Central Bank of Malaysia has implemented the Takaful Operator Framework (TOF), effective January 1, 2012, and revised in June 2013, and the Islamic Financial Services Act (IFSA) 2013 which was operative July 2013. These have been hailed as prominent milestones in the development and maturity of Islamic Finance and Takaful in Malaysia, ensuring the efficiency, health and sustainability of business, as well as safeguarding the interests of participants.

Indonesia

Indonesia is the world's third most populous democracy with approximately 245 million people, the majority of whom are Muslims. Indonesia has been enjoying robust economic growth, supported by buoyant demand from increasingly affluent households and business sectors. This is reflected in the country's GDP which rose to US$1284.79 billion in FY 13. Inflation also increased from 4.25% in 2012 to 7.25% in 2013.

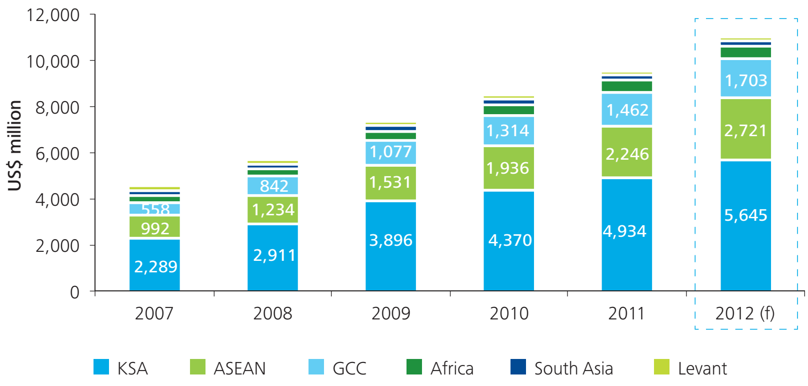
Indonesia is planning to introduce new initiatives to raise standards in the country's Takaful sector culminating in the phasing out of window operations in favor of full-fledged Takaful entities. Full-fledged Takaful firms will need to have a minimum capital of 50 billion Indonesian Rupiahs, which is likely to trigger mergers in the Takaful market to meet the new capital requirements.

Pakistan

Although Pakistan is one of the largest countries in Asia with a population of 182.58 million of whom 97% are Muslim, its economy continues to undergo challenges, such as electricity and gas shortages, and security threats deterring economic stability. Thus, real GDP growth rose to 4% in 2013 as compared to 3.7% in 2012, while GDP per capita minimally increased to US$1,295.36 in 2013. Inflation decreased from 11% in 2012 to 7.36% in 2013. However, the country's sovereign rating (S&P) remained at "B – Negative." In 2012, the Securities and Exchange Commission of Pakistan, through notification S.R.O 877(I)/2012 dated July 16, 2012, issued the Takaful rules, 2012, allowing conventional insurers to operate Takaful windows alongside their existing conventional insurance business, and conduct Takaful business, thus boosting competition and increasing the sector's market share.

In 2012, there were more than US$10.9 billion in gross contributions worldwide and it served as a haven for consumers seeking Islamic Finance products

Global gross Takaful contributions by region

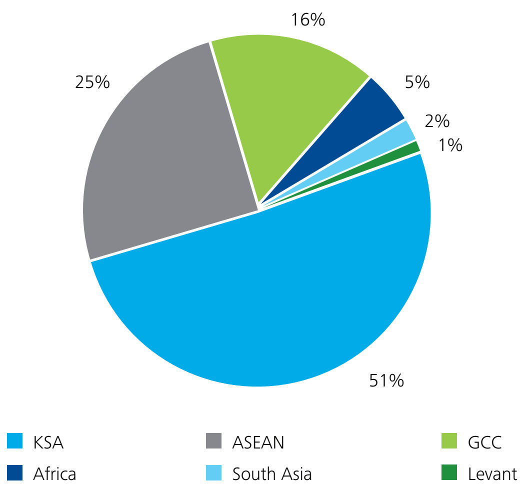


Source: World Islamic Insurance Directory 2013, Middle East Insurance Review

II. The insurance and Takaful industry – Trends and potential

Takaful is a fast growing industry with its core markets in the GCC and South Asia. In 2012, there were more than US$10.9 billion in gross contributions worldwide and it served as a haven for consumers seeking Islamic Finance products. The market for those products and especially Takaful, is mainly driven by KSA and Malaysia, and is expected to grow globally by 16% annually (2012 to 2017), compared to an average of 22% between 2007 and 2011. This would translate into more than US$17 billion in annual gross contributions by 2015, with the Kingdom of Saudi Arabia making up close to half that figure.

Share of global gross Takaful contributions by region (2012)



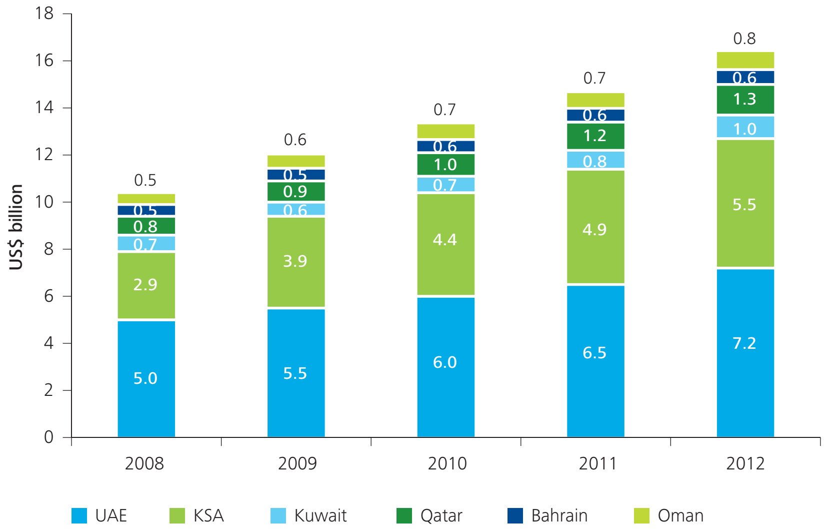
Source: World Islamic Insurance Directory 2013, Middle East Insurance Review

Middle East

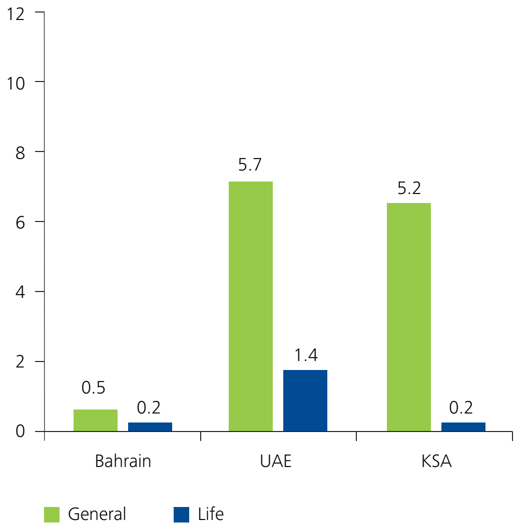
Size and composition of the insurance industry

The average annual revenue growth of the insurance industry in the GCC region reached 16.8% over the past six years.

Size and composition of the GCC insurance industry



Insurance composition (2012)



Source: GCC Insurance Industry Review 2013& Deloitte Analysis

The UAE and KSA dominated the regional insurance market, representing nearly 80% of gross written premiums (GWP). A reasonably-sized population, largely composed of expatriates and a receptive local community, makes the UAE the largest insurance market in the Gulf.

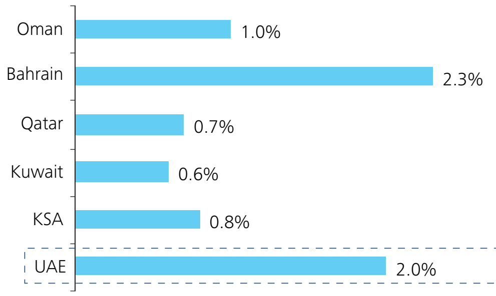
The GCC insurance market is dominated by general insurance, with Bahrain having the highest market share of life insurance compared to general insurance, reaching about 29% as of 2012.

A reasonably-sized population, largely composed of expatriates and a receptive local community, makes the UAE the largest insurance market in the Gulf

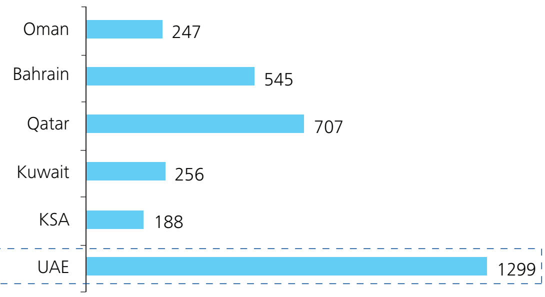
Penetration and density

Generally, the GCC insurance market is still underpenetrated and key market indicators trail the world average by a relatively large margin. In 2012, insurance penetration was measured to be 1.1%, which is around one-sixth of the global average.

Insurance penetration in GCC (2012)



Insurance density (US$) in the GCC (2012)



Source: GCC Insurance Industry Review 2013 & Deloitte Analysis

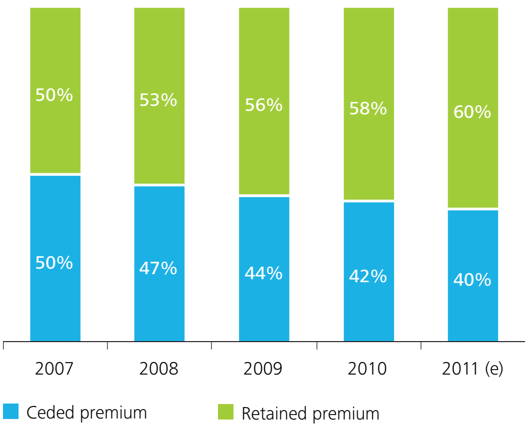
Bahrain has the highest insurance penetration in the Gulf region at 2.3%, noting that it is one of the earliest economies in the GCC to have initiated diversification in the non-oil sector and to build a mature framework within the entire financial services industry. With regard to insurance density, the UAE scores the highest within the GCC at nearly US$1,300 compared to the regional average of US$367.3.

Reinsurance and retention rates

The GCC has firm confidence in the future of the reinsurance sector; this is driven by the strong economic conditions, prospects, and significant growth in the primary insurance market. However, the reinsurance market in the GCC has not matured yet, and opportunities in the segment have not only captured the attention of local players, but have also attracted many regional and international companies seeking diversification.

Retention rates are slowly and steadily increasing as the insurance industry is modernizing, however, they are low and normally a considerable amount of risk is ceded to reinsurance companies, mostly in the commercial insurance business lines.

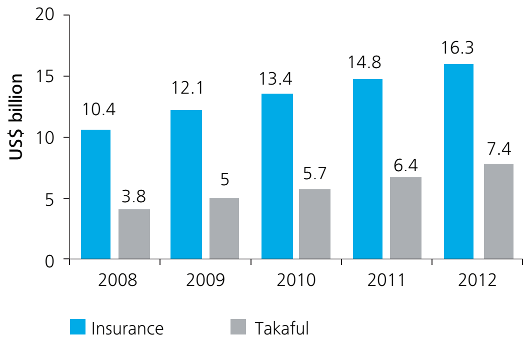
Proportion of non-life insurance premium ceded in the GCC



Source: GCC Insurance Industry Review 2013 & Deloitte Analysis

Since 2008 the GCC region – including KSA – recorded a stable insurance and Takaful industry growth with buoyant performance in some countries like the UAE (CAGR of 11.75% and 18.5% for the insurance and Takaful sectors respectively) with the Takaful industry witnessing a faster growth in the period 2008-2012. This is majorly attributed to the implementation of new regulations with compulsory health and motor insurance schemes.

GCC - GWP versus gross contributions

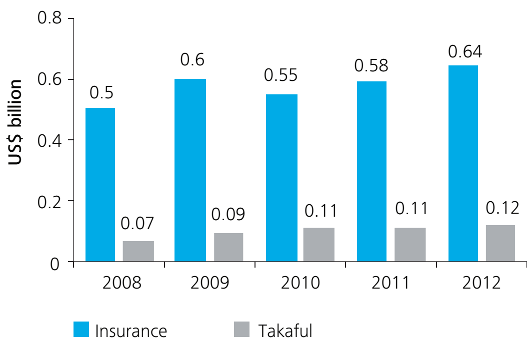


Source: GCC Insurance Industry Review 2013 & Deloitte Analysis

The Takaful industry in Bahrain has witnessed steady growth since the year 2008, with a CAGR of more than 70%, compared to the insurance industry which is growing at a slower rate and registered a CAGR of 20% in 2009. The insurance sector in the UAE is growing at a healthy rate, with the exception of the market's top players, while there are signs of market correction due to industry over-capacity. The Takaful industry in the UAE is growing at a faster pace with a CAGR of 22.1% compared to 9.6% for the insurance sector. In KSA a common legislation is applicable to both sectors and hence comparison is impossible.

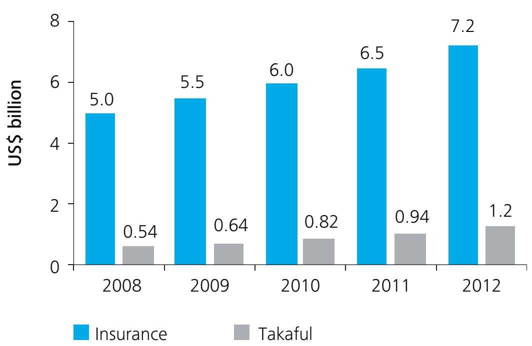
The insurance sector in the UAE is growing at a healthy rate, with the exception of the market's top players, while there are signs of market correction due to industry over-capacity

Bahrain - Insurance versus Takaful



Source: GCC Insurance Industry Review 2013 & Deloitte Analysis

UAE - Insurance versus Takaful



Source: GCC Insurance Industry Review 2013 & Deloitte Analysis

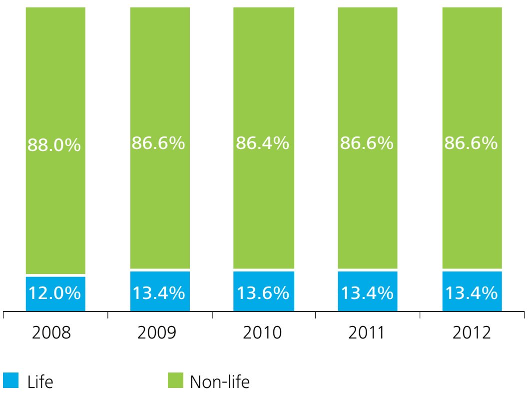
The Malaysian Takaful industry is expected to grow by 20% per annum for the next two years based on the growing trend of consumer acceptance and strengthened regulatory infrastructure

Insurance segments
In the GCC landscape, the general insurance segment contributes a larger proportion to the total insurance premiums, compared to family insurance. As of 2012, the contributions were estimated to be 13 to 14% of the overall Takaful market in the Gulf. The low family Takaful contributions in the GCC were mainly due to the following:

- The majority of the residents have so far refrained from taking life cover mainly for religious reasons.
- Most of the expatriates residing in Bahrain are manual laborers and have very limited capacity and access to insurance products, which has restricted the insurance sector's growth.
- Affluent expatriates in the GCC generally prefer to take life insurance schemes in their home countries.

Development and acceptance of life insurance products compliant with Islamic principles, the improvements in regulations in several GCC countries (e.g. mandating health and motor insurance) and increasing awareness about the benefits of insurance, have gradually brought about a change in the market dynamics in the region.

Breakdown of life and non-life insurance segments in the GCC

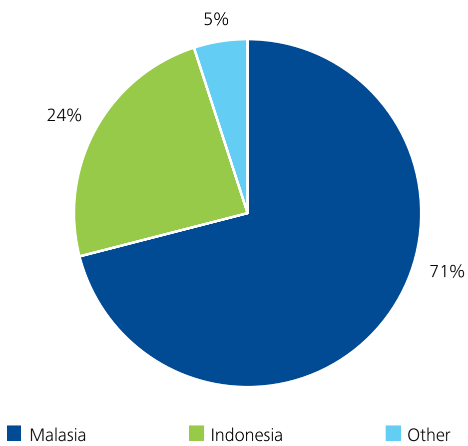


Source: GCC Insurance Industry Review 2013 & Deloitte Analysis

South Asia

Size and composition of the insurance industry
The insurance industry is an emerging market in Asia mainly due to the saturation in established markets. Over the years, various regulatory changes have taken shape to serve as platforms to encourage stronger industry governance, promote Takaful business growth focus, and expand the range of Sharia'-compliant investments.

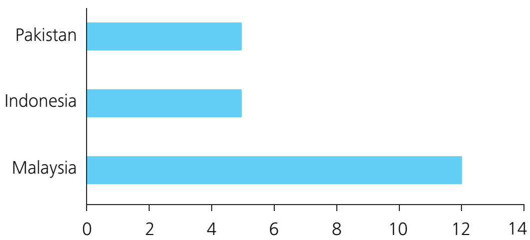
Share of Asian countries in gross Takaful contribution (2012)



Source: KFHR & Deloitte analysis

The Malaysian Takaful industry is expected to grow by 20% per annum for the next two years based on the growing trend of consumer acceptance and strengthened regulatory infrastructure. The potential for growth is higher in the family Takaful segment compared to conventional life insurance.

Number of full-fledged Takaful operators (2012)



Source: World Islamic Insurance Directory 2012 & Deloitte analysis

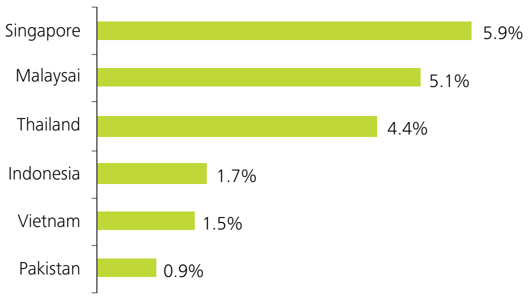
Similarly, Indonesia's insurance market attractiveness is supported by growing middle-class and affluent consumers. There is a growing awareness of the benefits of insurance among the country's younger population.

In contrast, Pakistan's insurance industry is relatively small. Until 2000, the insurance sector was under the regulatory purview of the Federal Ministry of Commerce, and the government of Pakistan which led to the fragmentation of the private sector industry, while public sector companies enjoyed a privileged status that helped capture business.

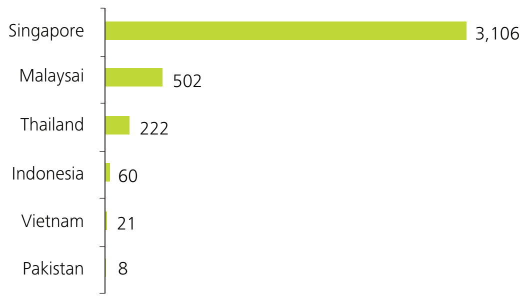
Penetration and density

Singapore leads the Asian market in insurance density and penetration followed by Malaysia and Thailand. The Indonesian and Pakistani markets are in a growth phase and demonstrate high potential for more growth.

Insurance penetration in South Asia (2011)



Insurance density (US$) in South Asia (2011)



Source: OECD Statistics (2013) and World Insurance 2011

The Pakistani insurance market has a high potential for growth compared to other regional countries such as Malaysia and Singapore, which have more mature markets. Insurance density, both life and general, was US$7.62 per capita in 2011 having gradually increased from 2006. Insurance penetration has also gone up, rising to 0.87% of GDP in 2011 compared to 0.68% of GDP in 2010.

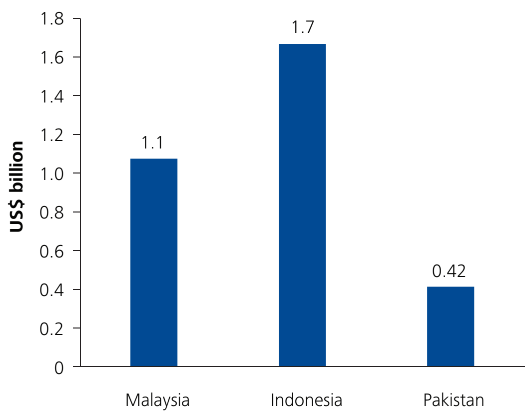
In contrast, Malaysia is plagued with comparatively low insurance penetration and density rates which have been gradually improving, led by the life insurance sector. Penetration of life insurance climbed to 4% of GDP in the year 2011, while non-life insurance increased to 1.8% of GDP in 2011. The Indonesian insurance industry has ample growth opportunities supported by the expanding local market and government initiatives to spur economic development through infrastructure enhancements.

Reinsurance and retention rates

South Asia is one of the fastest growing reinsurance markets in the world due to low penetration rates in general insurance providing opportunities within the reinsurance market.

The Pakistan reinsurance industry contains only one non-life reinsurance company and posted a marginal growth of 2.7 % over 2011 in its asset base. The opposite was true in both Malaysia and Indonesia which posted strong growth; Malaysia has seven companies accredited to offer reinsurance services in the country, while Indonesia has four native reinsurance companies which play a critical role in the market.

Non-life reinsurance market size

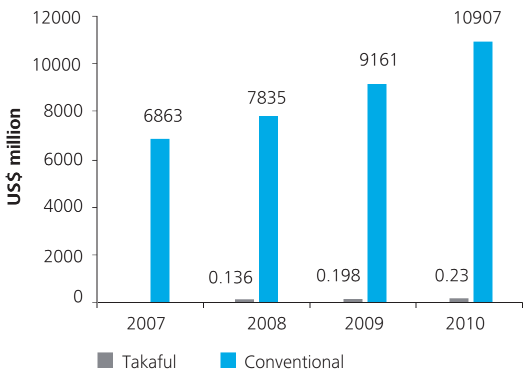


Source: QFC (2013) Report & Deloitte analysis

Insurances compared

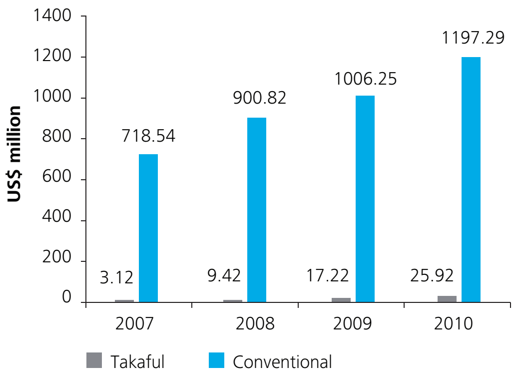
The potential for growth among Takaful operators remains high in South Asia due to the lack of awareness and misconceptions regarding conventional insurance and religious beliefs.

Indonesia: Gross premiums Takaful versus conventional insurance



Source: AAUI & Deloitte analysis

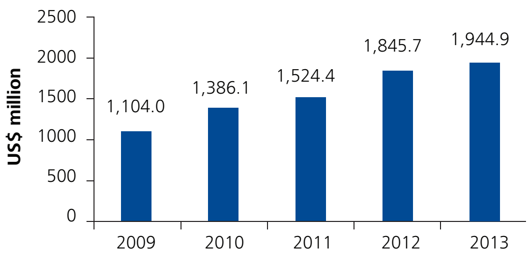
Pakistan: Gross premiums Takaful versus conventional insurance



Source: Wahab, 2011

Developments in Malaysia have proven to be more sustainable making the country's Takaful market the largest in the region with a share of 70% of Association of Southeast Asian Nations (ASEAN) gross Takaful contributions. In Pakistan, the growth in demand for Islamic insurance has seen a proliferation of new companies offering Islamic insurance products. Similarly, the Indonesian insurance industry has been forecasted to grow further, with written insurance premiums expected to triple by the end of 2014 to reach US$28.5 billion.

Net contributions income of Malaysia (Takaful)

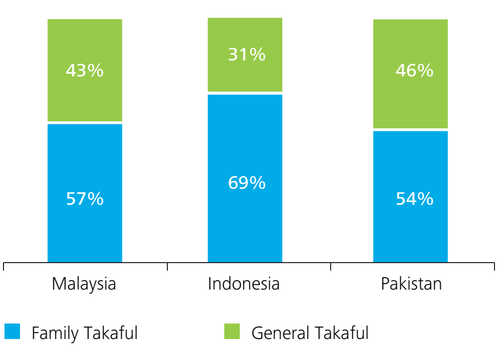


Source: Bank Negara Malaysia

Insurance segments

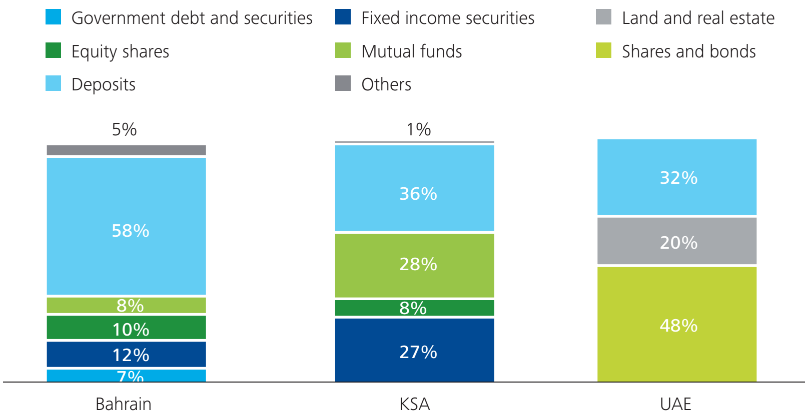
The life insurance sector in Pakistan has grown on the back of high premiums, thus improving the industry asset and premium concentration ratio. As before, the Malaysian insurance market continues to be dominated by family Takaful insurance, with its share of the market remaining at 57% in 2010. In contrast, the life insurance sector in Indonesia has been dominated by unit-linked products with a growth of 37.7 % in 2012 compared to 2011. In the general insurance sector, motor insurance has dominated the market with a 30.1% increase in its share in 2012.

Share of family and general Takaful contributions in South Asia (2010)

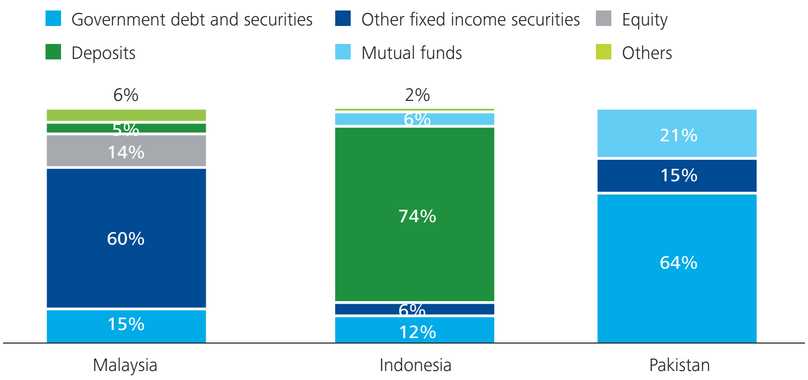


Source: KFHR & Deloitte analysis

Takaful operators in both continents are encouraged to consider regional and international investment opportunities in alternative asset classes like property, private equity, and commodities, which might provide great diversification benefits



Source: CBB Insurance review, SAMA Insurance market report, The Annual Report on the UAE Insurance Sector for 2012 & Deloitte analysis



Source: Takaful operators' financial statements, Peransuransian Insurance 2013 statics & Deloitte analysis

III. Investment allocation trends – Analysis and insights

Investment strategy and asset allocation decisions vary widely between the two markets: the GCC's investment portfolio is highly composed of deposits, while Southeast Asia (SEA)'s investment portfolio is highly composed of Sukuk. This is primarily a function of the product mix of each Takaful company and may differ slightly for family and general Takaful companies respectively. The portfolio composition of Takaful operators in both markets can also be determined by differences in regulatory framework, tax, Sharia' and general economic conditions.

With regard to the GCC, Takaful operators in KSA have by far the most diversified investment portfolio with investments allocated to deposits, debt securities, and mutual funds. Bahrain has approximately 60% of investments allocated to deposits, while in the UAE the collective investments of Takaful and insurance companies are mostly utilized in the capital market (shares and bonds).

Generally, the South Asian investment landscape presents a contradictory picture to that of the GCC: in Malaysia where Takaful operators utilize the Islamic capital market to invest, corporate Sukuk is the primary asset class followed by government Sukuk and equity shares, while in Pakistan, investments are highly concentrated in government securities followed by mutual funds. Surprisingly, the investment composition of both fully-fledged Takaful operators as well as Islamic windows in Indonesia consist mostly of deposits just like their GCC counterparts.

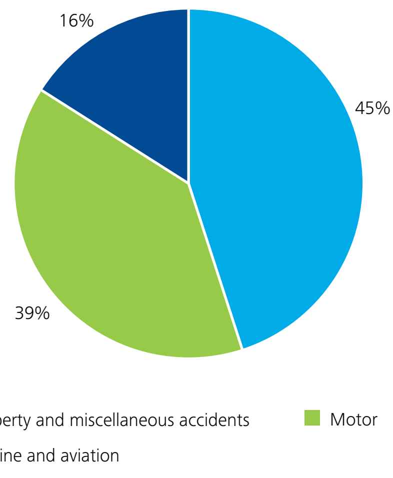
IV. Product versatility – Stressing innovation

Composition and development of insurance products

Currently the UAE holds the highest share of general insurance premiums, followed closely by KSA.

Health and motor insurance products dominate the GCC market due to country regulations, such as in the UAE where motor and health insurance cover is mandatory for all residents. The UAE also provides the greatest diversification in terms of family Takaful products and general Takaful products targeting niches such as yacht and boat insurance, and deterioration of stock insurance while the insurance markets of Bahrain and KSA offer more general products such as theft insurance and property insurance.

GCC general insurance business split (2010)



Takaful operators in South Asia offer a variety of products and services compared to conventional insurance companies. Malaysia is the leader in the global family Takaful market with a 73% market share, and offers the most diversified corporate insurance products, both general and life. The Indonesian market is slowly being penetrated with family Takaful products while Pakistani Takaful companies offer a diverse range of family Takaful products including education, health and saving plans.

Islamic banks remain the most popular and competent distribution method across the GCC, while in South Asia the Takaful business is dependent on traditional agencies

Distribution technologies

A distribution channel of Takaful products through Islamic banks is the most popular and competent distribution method across the GCC where family Takaful products are offered as financial planning solutions under wealth management. Fully equipped websites are favored by all GCC operators, which offer quick quotes and customer services. KSA-based Company H and UAE-based Company G have a lively presence on social networking sites such as Facebook. Only the Bahrain-based Company E offers mobile application facilities.

In South Asia, the Takaful business is dependent on building relationships with customers. In Malaysia, the largest family Takaful market globally, the biggest role has been played by traditional agencies in distributing products. Indonesian companies have also resorted to distribution via agencies, and Pakistan insurance companies favor Bancatakaful and direct channels for their product distribution. All three countries make good use of technology such as websites to communicate information to potential and existing customers.

The criterion for selecting these firms was largely influenced by the size and breadth of each one's product offerings, but more importantly, the readiness and availability of financial information

V. Financial analysis of selected Takaful operators

This section looks at the business and financial performance of the Takaful sector in the GCC and South Asia: two Takaful operators from each of Bahrain, UAE and KSA in the Middle East, as well as two Takaful operators from each of Malaysia, Indonesia and Pakistan, were selected. The criterion for selecting these firms was largely influenced by the size and breadth of each one's product offerings, but more importantly, the readiness and availability of financial information.

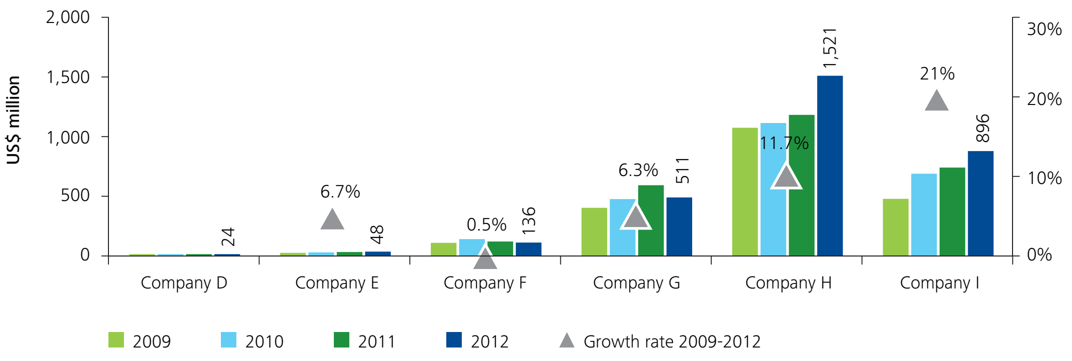
Middle East

Country	Company	Size (value of assets in US$M)	Turnover (in US$M)
Bahrain	Company D	48.88	14.22
	Company E	85.1	25.4
UAE	Company F	142.3	57
	Company G	1,171.8	252.3
KSA	Company H	2,657	1,327
	Company I	1,498.6	713.6

1. Financial performance

1.1. GWI

GWI premium

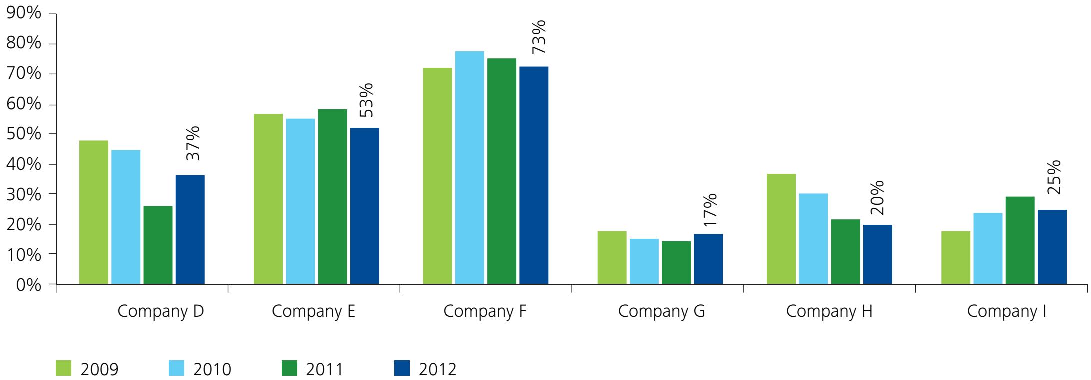


KSA insurers, Company H and Company I, were among the industry's outperformers with a three-year GWP CAGR of 11.7% and 21.5% respectively. Most of the other regional players experienced significantly lower growth. However, insurers continue to expect a recovery in growth momentum in view of strong fundamental factors like growing population, rising GDP, and the current under-penetration in the industry.

Product diversification through new Sharia'-compliant instruments has made Takaful operators financially strong and has enhanced their risk-taking ability

1.2. Reinsurance ratio

Reinsurance ratio



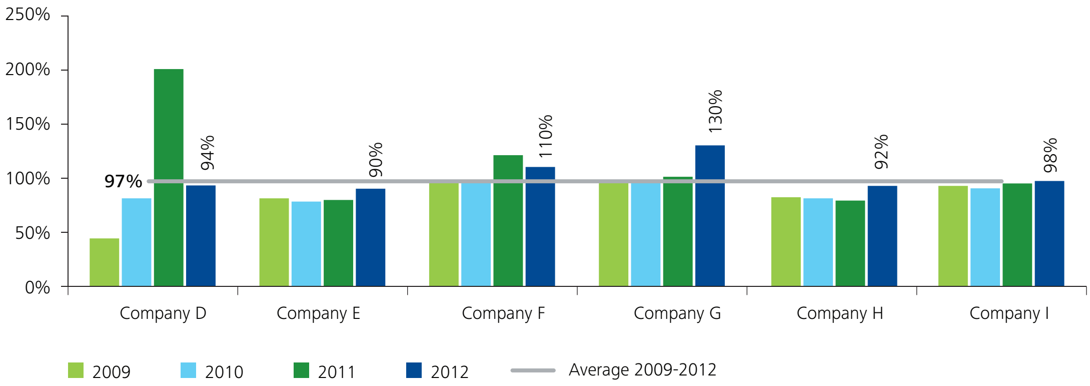
Product diversification through new Sharia'-compliant instruments has made Takaful operators financially strong and has enhanced their risk-taking ability. Among Gulf countries, Company E and Company F have ceded the highest underwriting risks to the reinsurance segment in 2011 and 2012, though their ratios declined in 2012, year-on-year. Regulations in KSA require a minimum retention threshold for local insurers.

2. Profitability

2.1. Combined ratio

The combined ratio is the most popular measure of profitability used by insurance companies. A ratio of more than 100% implies that the company is paying out more in claims and expenses than contributions received.

Combined ratio



Net claims incurred, commissions paid and other underwriting expenses impact combined ratio. The combined ratio for Company F and Company G rose above 100% in 2011-2012, meaning that more was being paid out than being cashed, while Company D ratio has been highly fluctuating over the past 4 years with 2011 recording the highest at 202% and the year 2009 the lowest. Bahrain-based firms had ratios below the industry average depicting their strong ability to handle claims liabilities more efficiently than their peers in this group.

2.2. Return on Investment (ROI)

ROI is the income that the company earns on its various investments in securities, properties and other trading investments.

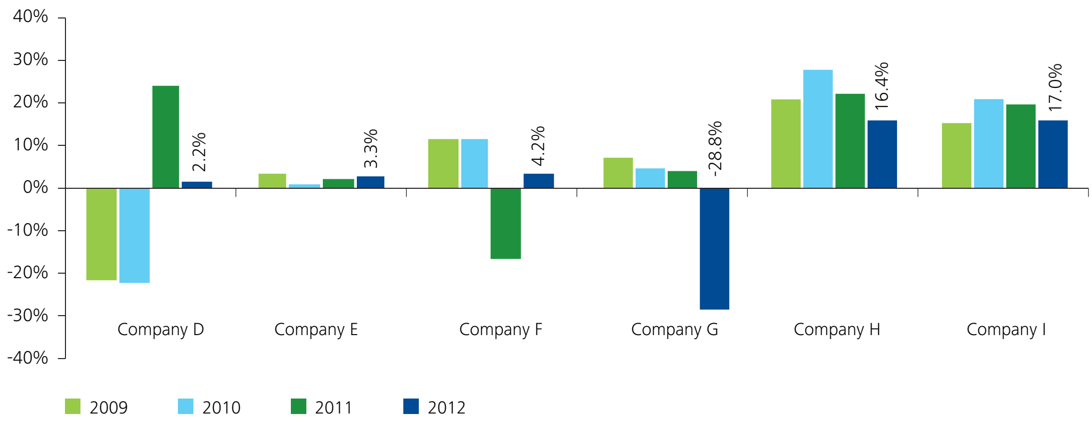
ROI

Bahrain insurers have achieved relatively positive and stable returns on investment, while counterparts in KSA and the UAE experienced volatile returns due to exposure in the troubled securities and real estate markets.

2.3. Return on Equity (ROE)

ROE closely mirrors the investment performance of the Takaful players.

ROE



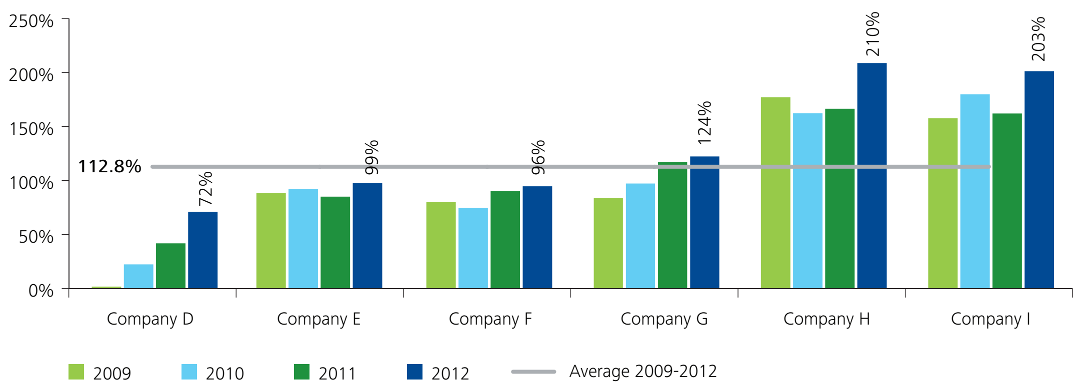
There have been fluctuations in ROE results with the exception of KSA insurers. In general, an ROE of 10 –15% is considered acceptable for insurance companies. The fluctuations in ROE show that these companies are not consistently profitable.

3. Leverage

3.1. Net contribution to equity

Net contribution to equity shows the risk levels of the company due to written contributions relative to the level of equity capital.

Net contribution to equity

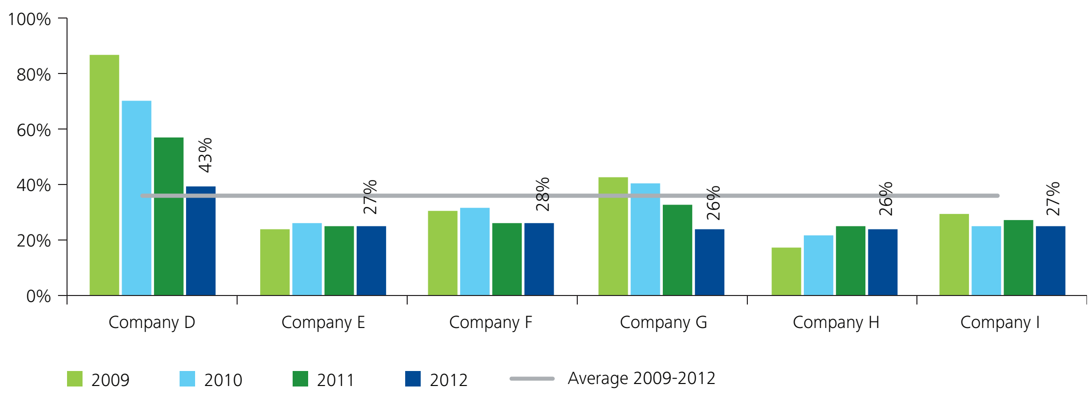


The four-year average for this study's sample companies stood at 112.8%. The ratio is highest for UAE insurers, at 210% and 203% in 2012, indicating higher risk. Generally speaking, the risk-taking capability increases as companies mature. A high ratio signals strong growth and is desirable from an equity standpoint, but may cause concerns from a credit standpoint, particularly if growth is in new lines of business or areas where a limited claims history exists.

3.2. Total equity to total assets

A more static measure of leverage is the equity to total assets ratio.

Equity to assets



This ratio also declined in 2012 year-on-year, and registered a four-year average of 36% at the end of 2012, indicating increasing leverage amongst the companies. Company D began at a relatively stronger position compared to its peer group, but decreased to 43% in 2012.

South Asia

Country	Company	Size (value of assets in US$M)	Turnover (in US$M)
Malaysia	Company A	3,117.59	528.84
	Company J	320.22	226.11
Indonesia	Company K	198.02	44.31
	Company M	319.51	153.29
Pakistan	Company B	38.35	3.67
	Company C	10.46	2.37

1. Financial performance

1.1. GWP

The South Asian market is experiencing rapid growth in its representative constituents especially Pakistan with a three-year GWP CAGR of 102.3% and 30.5% in Company B and Company C respectively. The market is championed by Malaysia, specifically Company A, with GWP increasing to US$539 million in 2012. In the long-term, Takaful opportunities lie in rapid growth markets such as Indonesia and Pakistan whose favorable demographics provide for a strong family Takaful demand.

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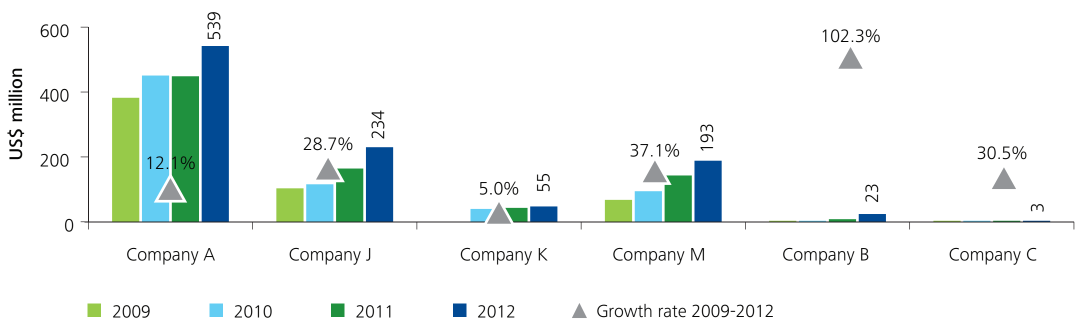
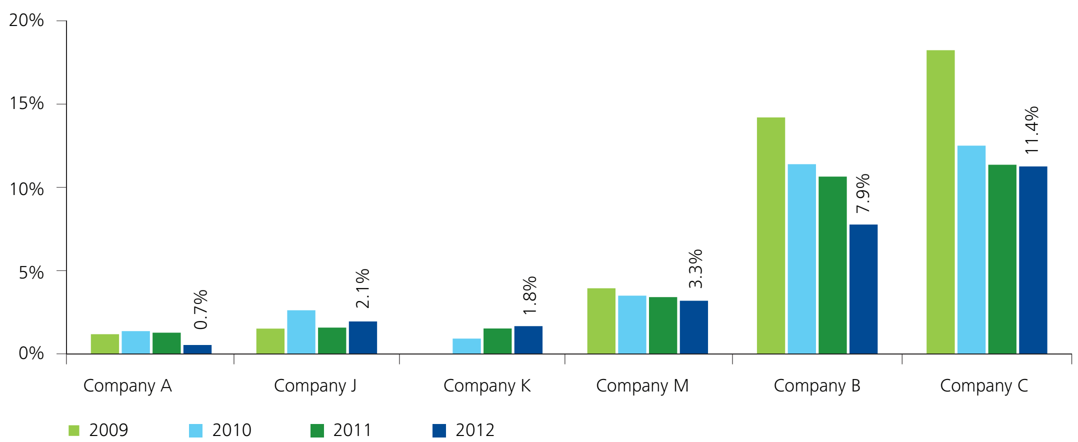
GWI premium



1.2. Reinsurance ratio

The reinsurance ratio is significantly lower in the South Asian market, the highest being in Pakistan. This can be attributed to the high concentration of relatively lower-risk family Takaful business in the South Asian Takaful market compared to the GCC Takaful market.

Reinsurance ratio

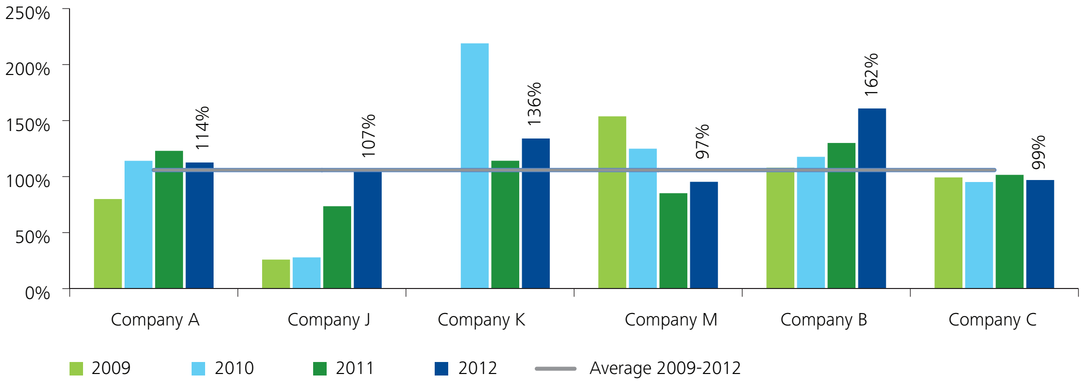


2. Profitability

2.1. Combined ratio

Between 2009 and 2012, and with the exception of Company C in Pakistan, none of the companies consistently fell below the peer group's average combined ratio of 106%; this can be attributed to factors such as aggressive pricing and a bias towards longer-term Takaful products providing investment opportunities in the South Asian market.

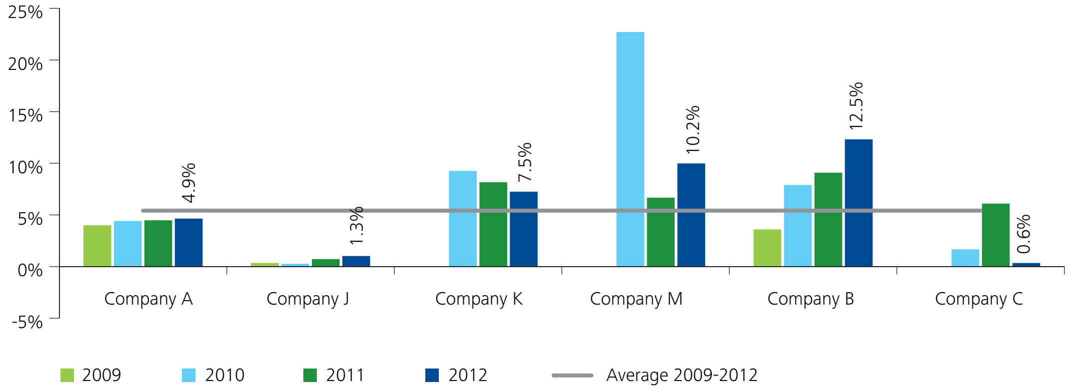
Combined ratio



All operators experienced a decline in their combined ratio with the exception of Indonesia's Company J whose ratio rose due to a sharp increase in underwriting expenses in 2012, and also Company B, whose ratio went up due to higher claims incurred.

2.2. Return on Investment

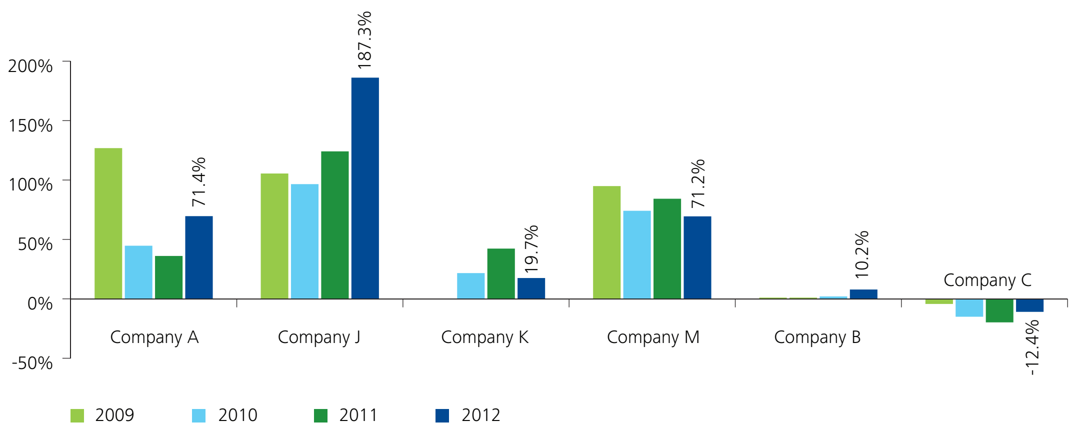
ROI



In Malaysia, returns improve between 2009 and 2012 but remained persistently lower than those of Indonesia and Pakistan. It is worth noting that Company B is consistently registering increasing returns with a three-year CAGR of 48%.

2.3. Return on Equity

ROE

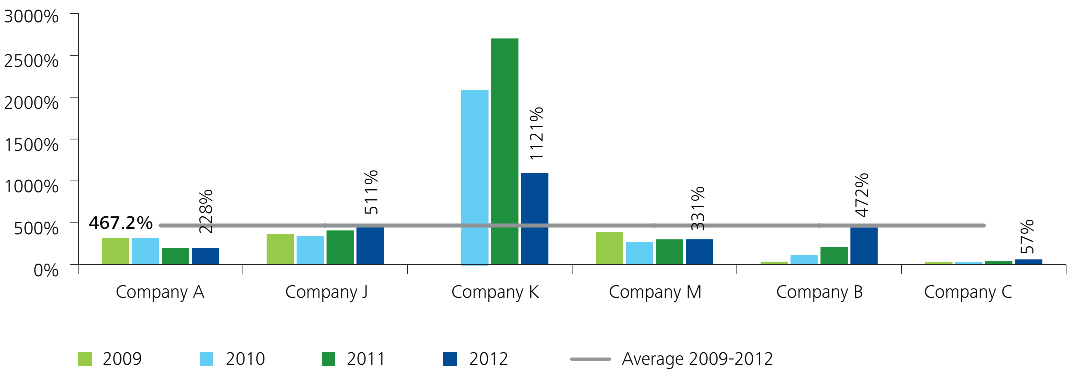


All Takaful operators in this particular peer group witnessed a positive ROE in 2012 with the exception of Company C. Company J achieved the most attractive ROE during the period, increasing from 107% in 2009 to 187% in 2012. It is interesting to note that the capital structure differed between the sub-markets where companies from Pakistan relied more on equity financing than companies from Malaysia and Indonesia did; this explains the divergence in ROE figures between the sub-markets.

3. Leverage

3.1. Net contribution to equity

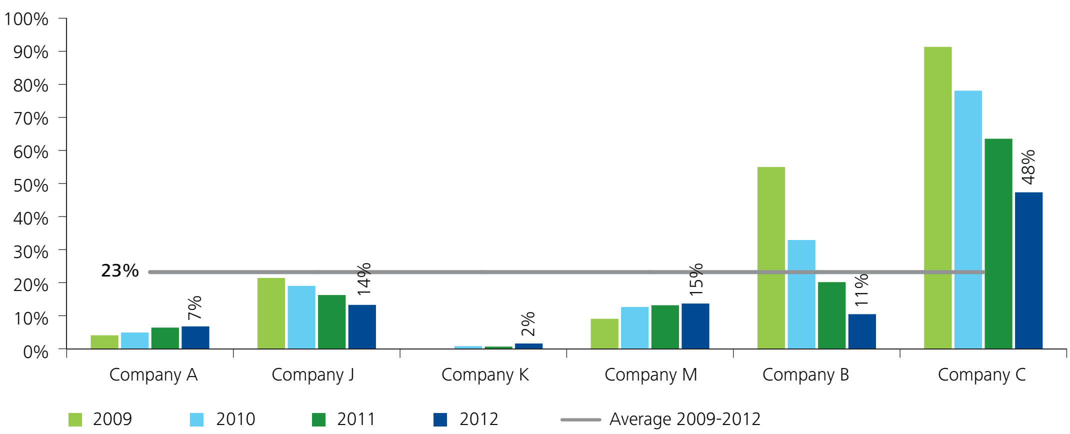
Net contribution to equity



The four-year average for this study's sample companies stood at 467.2%, which is understandable in mature markets. However Company K stands out among them, suggesting an excessive risk-taking appetite, although higher net contributions were eventually absorbed by higher claims leaving the company with lower profitability compared to its peers. Company C had the lowest ratio among the peer group during the four-year period, suggesting a more conservative risk undertaking.

3.2. Total equity to total assets

Equity to assets

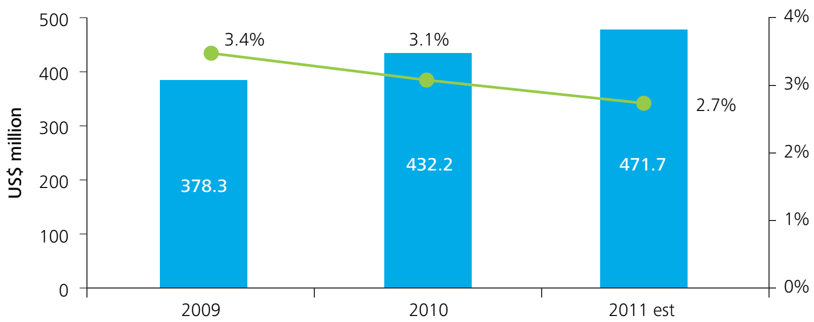


The total equity to total assets ratio is significantly higher in Company C compared to its peer group, indicating a higher reliance on equity financing. Company K has the highest leverage levels among the peer group with its equity to assets ratio reaching 2% in 2012, almost fully financed with leverage.

Emerging niche market: Africa rising

The Islamic investment market in Africa is growing with wide opportunities for Takaful operators to hold a spread of Sharia'-compliant investments and assuage any concerns a regulator may have. There has been a gradual increase in the gross contribution income in Africa from US$378.3 million in 2009 to an estimated US$432.2 million in 2011, an increase of about 25% in gross contribution income in these three years.

Takaful gross contribution income and growth (%) in Africa



Source: World Islamic Insurance Directory 2013 & Deloitte Analysis

The Islamic investment market in Africa is growing with wide opportunities for Takaful operators to hold a spread of Sharia'-compliant investments and assuage any concerns a regulator may have

Sudan clearly leads the African region with a gross contribution income of US$363.4 million in 2010, followed by Egypt with gross contribution income of US$58.9 million in the same year. However, there are other countries in the African region at their initial stage in the Takaful industry, and these include Kenya, Nigeria and Tunisia.

I. Kenya

Economic overview

According to CIA World Fact book estimates, Kenya's GDP (PPP) was US$76.07 billion in 2012, and nominal GDP was US$41.84 billion in the same year. Kenya's population is placed at 39 million, out of which more than 10% is considered Muslim. As of March 2014, Kenya's economic prospects were positive with above 5% GDP growth expected, largely because of the expansion in tourism, telecommunications, and recovery in agriculture. The potential market for Takaful products is projected to be around a quarter of the estimated four million Muslims in the country.

Institutional support

The Insurance Regulatory Authority (IRA) Strategic Plan (2013 – 2018) aims to improve insurance penetration from 3.1% in 2012 to 3.5% by 2018. The IRA has placed guidelines in its document regarding Takaful development and has given a timeframe for the completion of Takaful development by December 2014.

Market practice

There are a number of Takaful operators in Kenya offering Sharia'-compliant Takaful products from basic motor vehicle products to complex pension schemes, such as the Takaful Umbrella Fund. Companies distribute their products through registered brokers and agents.

II. Nigeria

Economic overview

Nigeria, whose total population of 170 million (51% Muslim) is growing at a high rate of 2.4% per annum, is considered a favorable destination for Takaful operators. According to estimates by the CIA World Fact book, the GDP of Nigeria was US$522 billion in 2013, with contributions from agriculture standing at 40% and the services sector at 30%. The insurance penetration of the country in 2010 was recorded at only 0.6%. Moreover, Nigeria's favorable status is also related to:

- The existence of an Islamic banking system in Nigeria, with a Sharia' legal system in operation and an apex court called the Sharia' Court of Appeal.
- A thriving oil industry, making Nigeria Africa's top oil producer.

Institutional support

The National Insurance Commission (NAICOM) – Nigeria – has already announced the release of its Takaful insurance guidelines and registration requirements to the insurance industry and other stakeholders in order to increase insurance penetration in Nigeria. The regulator has also devised a minimum deposit requirement and risk-based capital requirements along with the provision of the establishment of an Advisory Council of Experts (ACE) for Takaful operators.

Market practice

NAICOM approved three insurers in 2008 for Takaful products and issued guidelines for Takaful operations in 2013.

Company L is licensed by NAICOM. Company L is a segregated group which offers Sharia'-compliant life and non-life products. The products of Halal Takaful range from individual family to group products.

III. Tunisia

Economic overview

Based on CIA World Fact book estimates of a GDP (PPP) of US$105.3 billion and growth rate of 3%, dominated by the services sector which accounts for 53.7%, Tunisia presents an enormous opportunity for Takaful expansion. The Takaful industry in Tunisia is still in its very initial stage but it is expected to account for 10-12% of the market in the next five years, according to the Middle Eastern Insurance Review of the African region. The estimated population of the country is around 10.7 million with the majority being Muslim, and Islam designated as the state religion.

The Takaful industry in Tunisia is still in its very initial stage but it is expected to account for 10-12% of the market in the next five years, according to the Middle Eastern Insurance Review of the African region

Institutional support

The Tunisian National Constituent Assembly (NCA) inserted separate chapters in the insurance code for the establishment of a legislative framework to rule Takaful insurance in July 2014. Through this law, Takaful has become a regulated framework in the system, with regulations made for Takaful insurance, and financial management of Takaful insurance companies.

Market practice

Takaful has been available in Tunisia since 1982. This was followed by the establishment of a re-Takaful operator despite the absence of a specific regulatory framework. More companies were established, offering a wide range of Takaful and re-Takaful products since 2011. There are presently three Takaful operators in the country.

A third opinion: the prospects and future for Takaful

A practitioners' perspective

The global Takaful insurance industry is responding to changes in the competitive landscape with many of the same challenges addressed in this report, such as regulatory inconsistency, shortages of Sharia'-compliant investment asset classes, product innovation, and investing in talent. In this section, we present strategic insights from industry practitioners on the fronts discussed.

The regulatory front

"The evolution of regulatory developments in several Takaful markets and the expansion of the Sharia'-compliant investments universe, especially Sukuk, are having a positive impact on the industry," said Sohail Jaffer, Deputy CEO, FWU Group. He added, "The involvement of certain global insurance brands in the Takaful space is encouraging and has enhanced best practices and raised the performance bar especially with the increasing deployment of digital applications."

"Well capitalized and well managed Takaful operators stand to benefit as superior transparency and regulatory supervision are ensured," said Sabeen Saleem, CEO, Islamic International rating agency (IIRA). "Gradually moving towards 'Solvency II standards' and improvements to regulatory requirements, may also enhance the overall confidence of market participants," he added.

"Besides an effective regulatory infrastructure, the role of the Sharia' committee is crucial in observing and supervising not only the technical operation of the Takaful operator but also on the marketing side, so that Sharia'-compliance is met from one end to another. In this case, the Sharia' committee can be seen as an enabler for greater linkages of Takaful markets globally.

The evolution of regulatory developments in several Takaful markets and the expansion of the Sharia'-compliant investments universe, especially Sukuk, are having a positive impact on the industry

Sharia' committee members must be able to address and bridge any issues related to cross-border product acceptance among various jurisdictions," said Daud Vicary Abdullah, President and CEO, INCEIF.

"Takaful operators must urgently re-visit with regulators and stakeholders their very essence and legal structures. Convergence back to the mutual norms is a pre-requisite to long-term differentiation and closer adherence to original Takaful virtues and principles. Much is written on the ultimate benefits of mutual risk sharing versus stock risk exchanges, not to be elaborated here," said Dr. Omar Fisher, Khidr Solutions Consultancy, adding "As Basel II and III requirements approach full adoption, Takaful operators will be hard pressed to conform to risk weighted capital and matching of assets and liabilities, as compared with conventional insurers."

"It is also important for regulators to provide a conducive regulatory infrastructure which enables the Takaful operator to operate effectively. Collaborative efforts and continuous support from government and regulators have been the critical factors in enhancing the resilience and robustness of the industry. In the case of Malaysia, the recent introduction of unified laws for the Islamic financial services, the Islamic Financial Services Act 2013, provides a clear and comprehensive direction and support for the Islamic financial services industry. In terms of education and training, the industry in Malaysia for example, is highly supported by INCEIF, Islamic Banking and Finance Institute Malaysia (IBFIM), and International Centre for Leadership in Finance (ICLIF). These are dedicated institutions with a specific mandate to undertake research and consultancy in Islamic Finance, including Takaful. The Islamic Sharia' Research Academy (ISRA) is a recent institution which is responsible for conducting applied Sharia' research on contemporary Islamic Finance issues," said Daud Vicary Abdulla.

The operational front

"The industry faces stiff competition from larger and well established conventional insurance companies that in a large part outweigh their Islamic counterparts in balance sheet strength and business mix, enabling them to underwrite bigger risks. This presents a dilemma for Takaful operators that require a diversified and large pool of contributions to achieve optimal efficiency in business operations, while corporate customers in Islamic countries, though willing, are hesitant to obtain Takaful coverage citing the weaker financial strength of Takaful companies as a major reason," argues Sabeen Saleem.

"The broadening of distribution channels beyond banks to include direct marketing, brokers, corporates and other affinity groups has accelerated the growth of Takaful," said Sohail Jaffer.

"The Takaful industry seems to be enjoying market success at introduction, yet operators are struggling (in general) to scale up and hence reach clear profitability. In the absence of any such scale, the higher overhead expenses and high operating expenses cannot be amortized efficiently, compared to their larger scale conventional counterparties. This is a significant challenge for Takaful players in the near term. In addition, their departure and deviation from the original mutual principles in Takaful operations has resulted in ambiguity amongst customers and a poor visibility of Takaful's distinctive image and scope of purpose," said Dr. Omar Fisher.

The broadening of distribution channels beyond banks to include direct marketing, brokers, corporates and other affinity groups has accelerated the growth of Takaful

The financial and investment front

"The success of the global Takaful market in the last five years has shown impressive double digit growth and sizeable gross written contribution (GWC), with Malaysia and GCC taking leadership as the backbone of the industry. The increasing profitability is driven through the improvement in liabilities pricing, operational efficiency, product risk diversification, liquidity and investment return. The asset allocation of Takaful institutions faces some challenges in maximizing the yield on investment and, at the same time, satisfying the regulatory requirements. This is primarily due to the availability and quality of each asset class within the Sharia'-compliant investment universe, along with the robustness of portfolio strategies. With the trend towards the adoption of a risk-based capital approach, there is a strong need of liquid Sukuk markets and Islamic Real Estate Investsment Trusts (REITs) in the region in order to reduce capital charges on asset risks.

Boosting the size of family funds is also seen necessary to better align family products (long-term in nature) to equities (long-term in risk-return profile)."*

"Collaboration amongst industry players to avoid underpricing and focusing on risk-based pricing would also facilitate in improving financial performance. Focus on these areas is also likely to strengthen the financial strength ratings of Takaful operators," said Sabeen Saleem.

"Through the enhancement of risk management, the Takaful operator can subsequently improve its investment portfolio and its product management. However, the challenge to get the right skills and knowledge as well as the expertise in the said area for Takaful business, is always the issue," pointed out Daud Vicary Abdullah.

The talent front

"Currently there are shortages in specific skills and capabilities in the Takaful business, namely actuarial capabilities and risk management expertise. In addition, the Takaful industry is highly in need of people who have good underwriting and qualitative skills. Those listed here are all technical knowledge and this requires human resources that have in-depth knowledge of both the insurance and Takaful concept. The shortage of experts and professionals in those areas would definitely pose a challenge to the Takaful industry to grow further," said Daud Vicary Abdullah. "Above all the technical skills and knowledge, strong ethical values and practices in Takaful come in between and are highly needed to ensure Sharia'-compliance in the Takaful industry. It is imperative for Takaful operators to observe standards of ethics in conducting business which form the basis of principles in the Takaful business. Ethical values and practices complement the hard and soft knowledge of the Takaful employees."

A thorough review of the origins of Takaful is recommended so that changes can be contemplated and adopted by the Takaful sector leaders in order to shift gears from the 'red ocean' of fierce competition in fragmented markets to a 'blue ocean' of new possibilities and community centered service

"The participation of larger Islamic financial groups in the industry and strengthening capitalization standards and risk management practices of Takaful operators would boost growth prospects," said Sabeen Saleem.

The growth market front

"The Takaful industry is well poised to expand beyond its home markets of Malaysia and the GCC," said Sohail Jaffer. "Significant untapped business potential exists in Indonesia, Turkey, Nigeria, Egypt, Maghreb countries and Europe (UK, France and Germany)."

"Africa has enormous potential and the Takaful market could capture between 7% and 15% in the near term and up to 35% in the longer term. The areas of highest potential are 'Bancassurance' using existing channels for distribution, Small and Medium Enterprises (SMEs) for business owners policy cover, long-term health and illness cover, and micro-Takaful - which needs product development and attention to which non-traditional distribution channels can be adapted," said Dr. Omar Fisher.

* **Concept Paper:** enabling synergies between solvency requirements, product strategies and asset allocation: industry perspectives, General Council for Islamic Banks & Financial Institutions (CIBAFI), October, 2014

"One noteworthy point here is the legacy of unpaid Qard Hassan or benevolent loans that will surely be a limitation on Takaful capital and a burden to future growth. A thorough review of the origins of Takaful is recommended so that changes can be contemplated and adopted by the Takaful sector leaders in order to shift gears from the 'red ocean' of fierce competition in fragmented markets to a 'blue ocean' of new possibilities and community centered service," Dr. Fisher stressed.

"Government initiatives for economic diversification, and public private partnership investments in various sectors, will provide new underwriting opportunities. Implementation of compulsory health insurance programs in different GCC countries will continue to create strong growth avenues for insurers," emphasized Fareed Lutfi, managing director of Dubai Insurance Group. "Awareness about insurance and its benefits remains low among typical GCC consumers, and many recognize insurance as an effective means of wealth protection, savings, and security, thus posing a challenge for retail sector growth," he added.

Concluding remarks

The recurrence of common themes throughout this report underscores the need for the Takaful industry to build comprehensive strategies in key areas that address the regulatory and investment environments. Regardless of the changing dynamics of the global financial marketplace, industry executives should focus on building their strategies in corporate governance, business models, and investment opportunities.

Clearly, as observed from the analysis of these three markets, Asia, the Middle East and Africa, there are gaps within the global regulatory framework for Takaful business. Takaful players operating in countries with a sound regulatory environment and level-playing field for Takaful business, experienced good returns on investment and gains in total assets held in the 2009-2012 period.

The most important limiting factor may be the market dynamics. The fragmented Takaful markets and those with overcrowded operators, such as in the UAE, will continue to experience fierce competition and make modest or little profits. The pricing wars and cannibalization that prevail in some markets need to be addressed. Product portfolios and distribution channels are fundamental to the growth of the industry.

In South Asia, in Malaysia, for example, the government is wholeheartedly supporting the industry and has set a penetration rate target of 5% per annum. Similar actions are required in the Middle East and Africa if the industry is to grow and play an important role in the economy by creating jobs and offering quality services to society.

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