The Dynamics of Takaful Markets of the Middle East and Malaysia: Similar Models, Different Approaches, Contrasting Fortunes

A.M.Best

Introduction

The concept of Sharia compliant insurance has gained significant momentum over the past 10 years, with the global takaful sector experiencing material growth in gross written contributions (GWC), which is expected to reach USD 20 billion by 2017. A.M. Best believes that the vast majority of contributions will originate from Malaysia and Saudi Arabia, which are considered the two key Sharia compliant markets, with the United Arab Emirates (UAE) also becoming an important growth area.

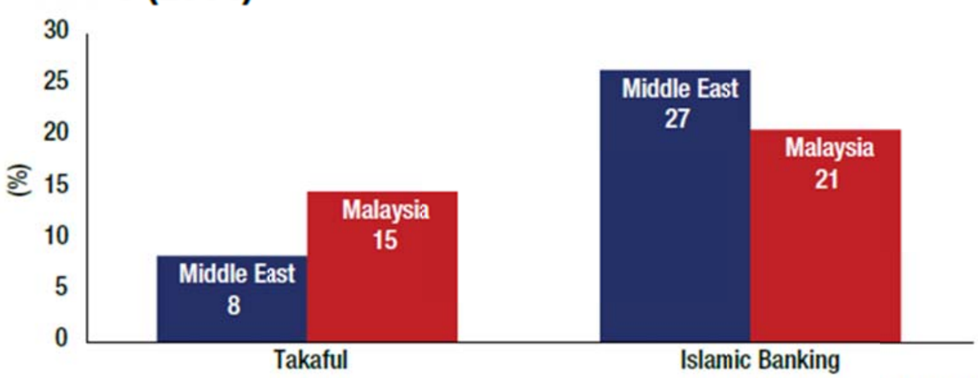
A perception persists in the global takaful market that Malaysia has been relatively successful in forming a vibrant takaful industry. In contrast, despite the Middle East having large Muslim populations, the consensus is that the takaful industry has struggled to establish a foothold and penetrate the market.

Malaysia leads the way in innovation and industry development

Qatar was the first country in the Middle East to have a takaful company, with Al-Khaleej Takaful Insurance and Reinsurance Company (now renamed Al-Khaleej Takaful Group) establishing itself in 1978, followed by Islamic Arab Insurance Company (Salama) in the UAE in 1979. Both of these companies pre-date the establishment of the first takaful company in Malaysia (Syarikat Takaful Malaysia in 1984). Despite the Middle East's early mover advantage, Malaysia's takaful industry has made stronger inroads into its local insurance market. This is seen in the level of takaful penetration (ratio of takaful contributions to overall insurance revenue) in the two regions as illustrated in Exhibit 1, where Malaysia reached nearly 15% penetration against the Middle East's modest 8% by 2014. Even though there are only 11 takaful companies in Malaysia, compared to 42 in the Middle East, Malaysia generates more gross contributions than the entire Middle East (excluding Saudi Arabia) combined. However it is worth noting that despite the progress Islamic insurance has made over the last decade, the sector still lags behind Islamic banking in terms of domestic traction, as evidenced by the stronger Islamic banking penetration ratios (ratio of Islamic banking assets to total banking assets) in Exhibit 1.

Exhibit 1

Middle East and Malaysia – Islamic Footprints in Financial Services (2014)



Sources: Swiss Re sigma No. 4/2015; MENA Insurance Directory 2015, World Bank, Malaysia Takaful Association, EY World Islamic Banking Competitiveness Report 2014, A.M. Best data and research

A.M. Best notes that the overall penetration figures for the Middle East mask underlying differences between various countries in the region. Bahrain and Qatar both enjoy good takaful penetration rates of

22% and 13%, respectively, however, both these markets are relatively small when compared to the UAE, which whilst having the largest takaful market in the region, has the lowest penetration rate (6%), which brings down the overall average for the Middle East.

Malaysia's takaful traction is all the more impressive when considered in the context of its local Muslim population. A dynamic and economically strong Muslim population is essential for the growth and commercial success of Sharia compliant financial solutions, as they represent the early buyers of these products. One of the reasons behind the plethora of takaful companies in the Middle East is the vast potential offered by the presence of large Muslim populations (both citizens and expatriates) in the region. The relatively strong Islamic banking penetration ratios in both Malaysia and the Middle East demonstrate a healthy demand for Sharia compliant financial solutions (see Exhibit 1). Despite having a stronger Islamic Banking penetration ratio, takaful companies in the Middle East have thus far failed to convince Sharia-conscious Muslims in the region to buy Sharia compliant insurance products. Malaysia has generated its strong takaful penetration rates with only 60% of its residents being Muslim, as compared to an average of 92% for the MENA region. Some takaful operators in Malaysia are attracting non-Muslims through competitive pricing and ability to regularly distribute surpluses to policyholders', outlining their value-added proposition.

1- Early Development of Takaful Regulations in Malaysia

One of the key reasons for Malaysia's stronger penetration ratio is its earlier development of takaful specific regulation. whilst the UAE had a takaful company in 1979, it did not issue takaful-specific regulations until 2010, and Qatar still lacks any such regulation. In A.M. Best's opinion, regulation is considered an important factor in the growth of any industry as it provides a level of security and confidence for both shareholders and clients to actively participate in its development.

2- Islamic Banking is better performing

Islamic banking has been relatively more successful than Islamic insurance in both markets due to its ability to create awareness and establish brands that differentiate themselves from conventional banks. As a result, they have been adept at selling their Sharia compliant products at higher price points than conventional banks. Whilst takaful operators in both the Middle East and Malaysia markets have tried to replicate these efforts, they have not yet achieved the same level of success.

3- Lack of Policyholders Surplus

A common issue in the Middle East is a severe lack of differentiation between takaful and conventional insurers, with most companies competing on the same product classes and utilizing similar distribution channels.

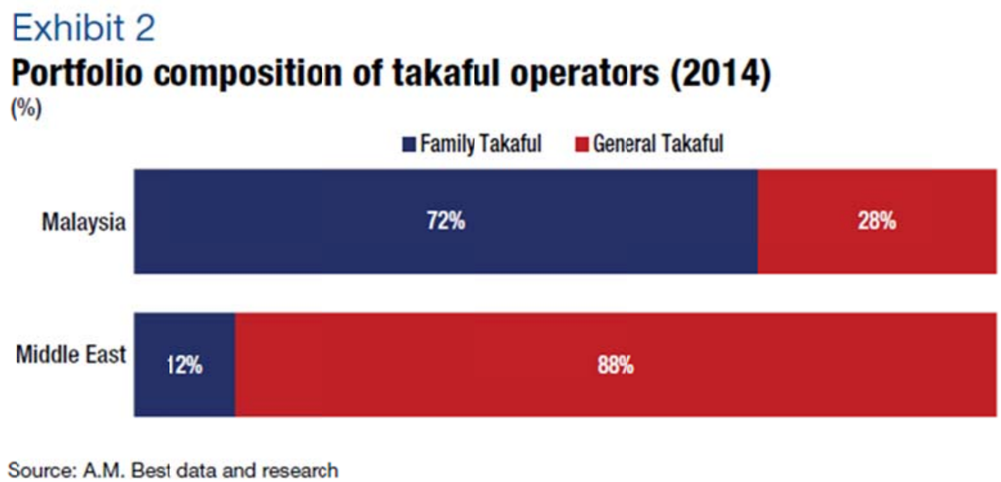
Practical realities where very few takaful companies in the Middle East make surplus distributions or provide discounts to policyholders. Moreover, takaful companies in the region are running ever-increasing deficits in their policyholders' funds caused by a combination of poor underwriting performance and excessively high wakala fees. In contrast, many Malaysian takaful operators have distributed surpluses to their customers, which has helped them retain cedants and distinguish themselves from conventional insurers. The lack of realization of promised benefits causes many takaful companies in the Middle East to lose their distinguishing attributes in the eyes of the customer and forces them to compete on price with conventional insurers.

4- Distribution Network

A further detriment for Middle East takaful companies is the distribution networks they utilise. Takaful products in the Middle East region are sold primarily through broker and agency distribution channels. In the UAE for example, 85% of takaful products are sold via this distribution channel, which makes price the key purchase consideration for customers. This contrasts with Malaysia where bancatakaful is a key distribution channel, which allows takaful companies to tap into the existing customer bases of Islamic banks (customers who have already shown willingness to buy Sharia compliant financial products). Given that Islamic banking penetration is higher in the Middle East, takaful operators in the region are depriving themselves of this important distribution channel.

5- Business Mix (Non life vs Life)

The different distribution strategies employed by takaful operators in the two markets are reflective of their divergent insurance portfolios. In the Middle East, the majority of insurance activity is concentrated in the non-life sector (called general takaful in Islamic insurance), with motor and medical insurance accounting for 72% of total GWC. Revenue from these two business lines is naturally easier to acquire via brokers and agents rather than banking channels. This is in contrast with Malaysia, where life assurance (called family takaful in Islamic insurance) makes up 64% of total GWC.



The lack of life/family takaful business is a key driver in the lower levels of Takaful penetration in the Middle East. Overall, the life insurance market for local nationals remains small in the region as customers fail to see the necessity for life insurance products due to both the generous social security schemes and limited awareness and knowledge of saving and protection products.

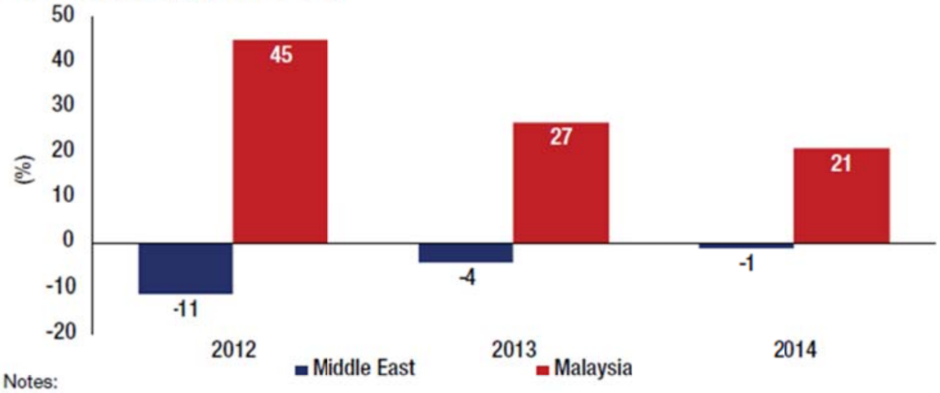
Contrasting profiles lead to divergent financial performance

In general, takaful companies in Malaysia have outperformed their Middle East counterparts in terms of underwriting results, whilst maintaining similar levels of investment returns. This can be seen in Exhibits 3 and 4, which show Returns on Equity for both underwriting and investment performance. As demonstrated in Exhibit 3, Middle Eastern takaful companies, in general, have struggled to generate income from their underwriting activities.

Middle East takaful operators have generated a lower investment return on equity in two out of the past three years compared to Malaysian takaful operators. Malaysia's investment returns on equity benefit from the lower level of capitalization when compared to the Middle Eastern operators, which are considered to have surplus capital.

Exhibit 3

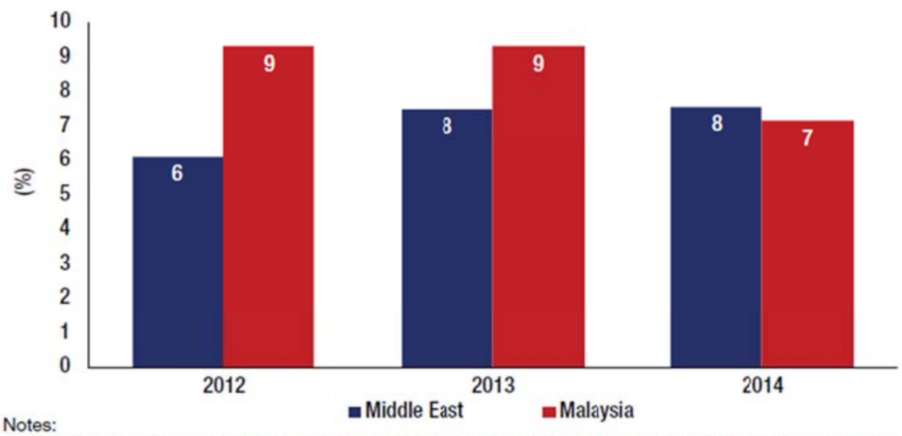
Middle East and Malaysia – Return on Equity – Underwriting (2012-14)



Notes:
A.M. Best defines Return on Equity - Underwriting as net underwriting profits divided by average capital and surplus
Source: A.M. Best data and research

Exhibit 4

Middle East and Malaysia – Return on Equity – Investments (2012-14)

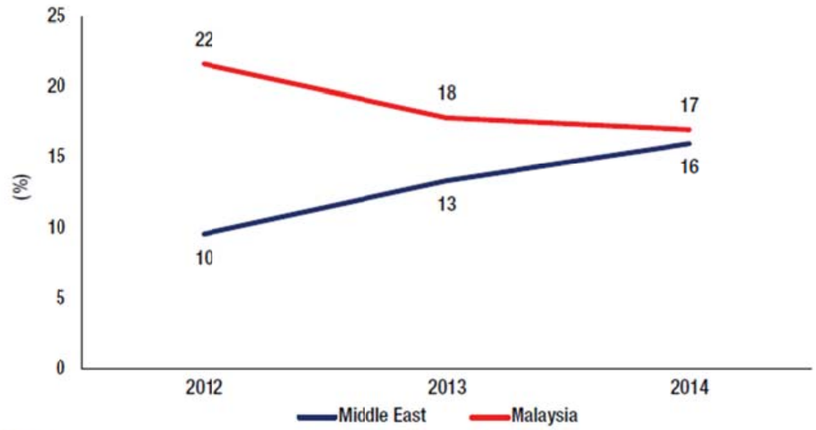


Notes:
A.M. Best defines Return on Equity - Investments as investment income divided by average capital and surplus
Source: A.M. Best data and research

One of the key drivers of insurance profitability for Malaysian operators is the strong returns experienced in their family takaful portfolios. Stem from their significantly lower expense ratios, which were almost half of Middle East family takaful expense ratios.As noted above, Middle East companies have spent considerable time and money to develop family takaful products which have not translated into significant revenue to absorb these costs.

Exhibit 5

Middle East and Malaysia – Family Takaful Profit Margins (2012-14)



Source: A.M. Best data and research

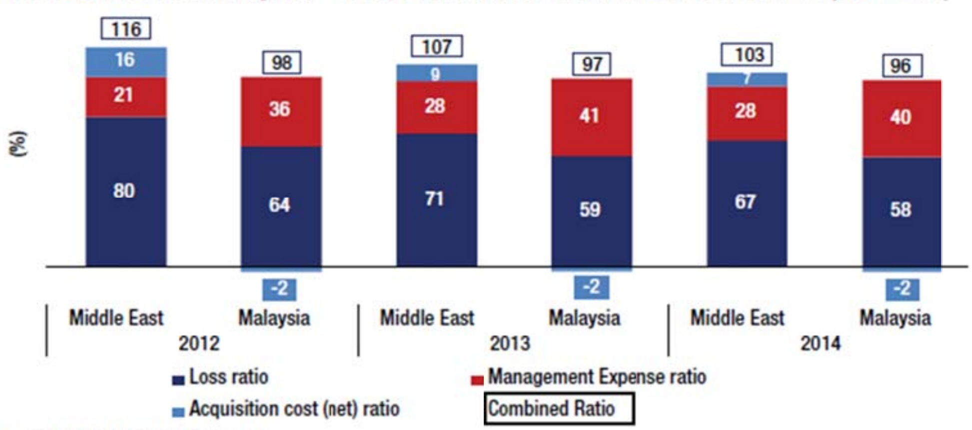
Malaysian companies also deliver stronger profitability in their general takaful portfolios (see Exhibit 6). Overall, Middle East takaful companies produce combined ratios (based on actual expenses) above 100%, whilst lower loss ratios in Malaysia help operators produce marginal yet profitable sub-100% combined ratios.

The Middle East insurance markets are considered to be concentrated. Generally, there are few large market participants that dominate their respective market with the remaining participants competing for the residual premiums. For example, in Kuwait, the top five insurers control approximately 59% of business written. Takaful operators generally fall into the latter group, where emphasis is placed on growth over profitability.

As demonstrated in Exhibit 6, both markets display low levels of net acquisition costs, However, despite ceding a higher proportion of their gross contributions, Middle East takaful companies still have a higher net acquisition cost ratio, whilst Malaysian operators are able to receive more commissions than they pay out. This stems from the broker and agency driven distribution networks in the Middle East.

Exhibit 6

Middle East and Malaysia – General Takaful Businss Performance (2012-14)



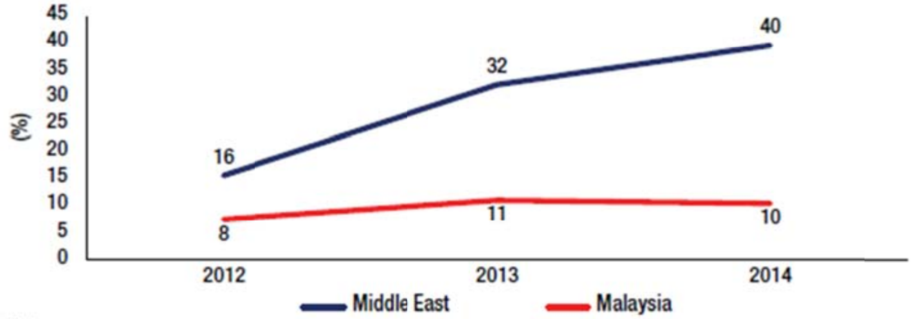
Source: A.M. Best data and research

A key component of A.M. Best's takaful rating methodology is for companies to demonstrate a good balance of earnings between the policyholders' and shareholders' funds.

Poor underwriting performance for Middle East takaful companies reduces their ability to generate profits in their policyholders' funds. This is further exacerbated by the high level of wakala and profit sharing fees charged by most Middle East companies. In theory, wakala fees are designed to cover the expenses incurred by the shareholders in management of the policyholders' fund, and to provide a reasonable margin for profit to cover the operator's cost of capital. Whilst profit sharing fees are not a regular feature in Middle East companies (given the low levels of underwriting profits), they are utilized regularly in the Malaysian market. As shown in Exhibit 7.

Exhibit 7

Middle East and Malaysia – Margin of Shareholder Fees Over Expenses Borne (2012-14)

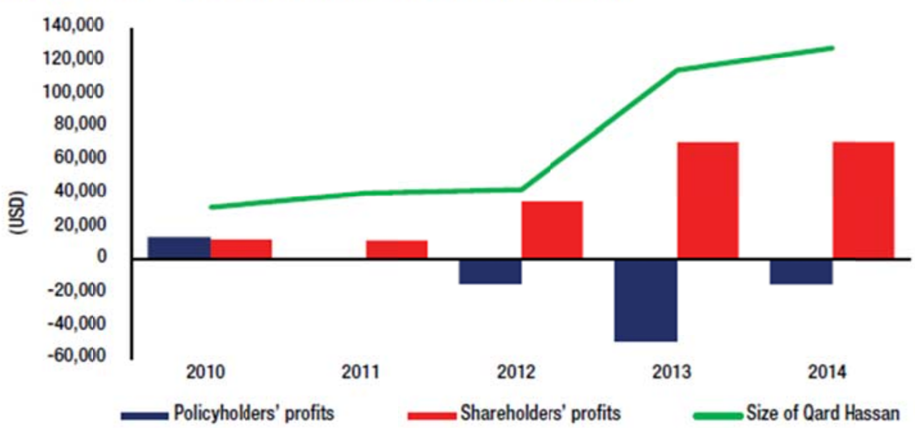


Notes:
Middle East analysis excludes Islamic Arab Insurance Co (Salama)
Source: A.M. Best data and research

The effect of allocating lower fees towards wakala and utilising a profit sharing mechanism incentivises management to work towards ensuring technical profitability, developing underwriting discipline and reducing the moral hazard of shareholders not sharing in the risks and rewards of running the policyholders' fund. This is seen in the lower loss ratios noted above for Malaysia. Conversely, the lack of profit sharing mechanisms and excessive wakala fees in the Middle East ensure the shareholders often benefit at the expense of policyholders. Therefore, whilst policyholder funds in the Middle East continue to report losses, in many cases, shareholder profits continue to rise. Exhibit 8 demonstrates the stark contrast between policyholder losses (based on wakala fees) and shareholder profits in the Middle East.

Exhibit 8

Middle East – Uneven Profit Distribution (2010-14)



Source: A.M. Best data and research

Takaful practitioners in the Middle East often point towards the Qard Hassan as a counterbalance towards transfer of profits and the moral hazard mentioned above. Theoretically speaking, the provision of a benevolent loan from the shareholders to the policyholders (which should be repaid from future underwriting profits) should increase management's drive towards improving underwriting profitability and reducing the wakala fee burden. However, in A.M. Best's opinion, Qard Hassan in the Middle East is treated merely as an accounting transaction, with no actual transfer or ring-fencing of assets. This leads to the 'Perpetual Qard Syndrome' wherein the deficits and Qard Hassan continue to grow without any intention of management to either write-off the loans or transfer assets across to the policyholders. Bahrain is an exception to this, given the regulatory requirements for transfer of assets to the policyholders' fund. Additionally, new takaful-specific regulations in the UAE require a write-off of the Qard Hassan every three years. A.M. Best believes these new regulations will help reduce the effects of 'Perpetual Qard Syndrome'.

Policyholder security depends on having sufficient liquidity to pay claims, either from independent capitalisation of the policyholders' fund or from the interest-free loan from shareholders. A.M. Best adopts a two-stage approach to the analysis of the risk-adjusted capitalisation of takaful companies. This is measured for the company as a whole, taking into account the balance sheets and operating activities of both funds, and again for the policyholders' fund on a standalone basis. In order to be considered for a secure rating, a takaful company must either have an adequate level of capitalisation on both a consolidated basis and within its policyholders' fund, or be adequately capitalised overall as well as existing in a sufficiently strong regulatory environment that demonstrates policyholder protection, such that the permanence of the Qard Hassan is guaranteed.

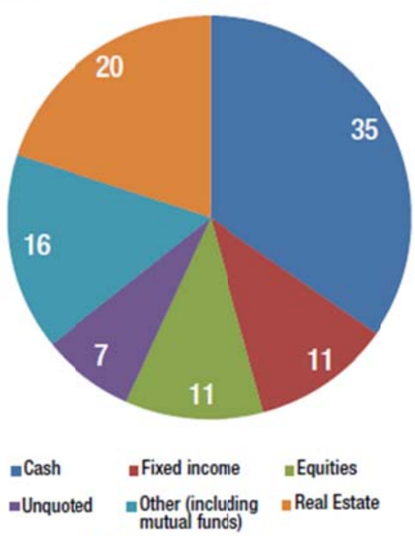
Investment options remain limited for Middle East takaful The development of Islamic finance in recent years has led to a surge in the number of Sharia compliant products being offered to investors and consumers. A key requirement for takaful (and retakaful) companies is the need to invest in Sharia compliant securities. Sukuk securities have grown in prominence in recent years, filling a gap in the market for investors requiring Sharia compliant low-risk fixed income assets. Despite sukuk issuance decreasing in 2015, the overall market has developed significantly from where it was ten years ago (see Exhibit 9).

The increases in Sharia compliant fixed income investment opportunities should, in theory, result in takaful operators de-risking their balance sheets and investing funds into sukuk bonds. Whilst this appears to be the case in Malaysia, Middle East companies continue to invest in riskier assets.

Exhibit 10a

Invested Assets – Middle East & North Africa (as at December 2014)

(%)

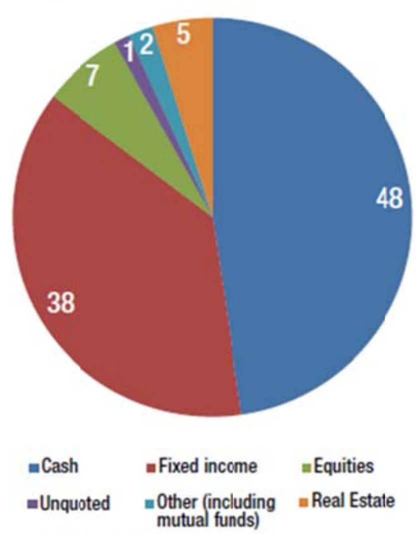


Source: A.M. Best data and research

Exhibit 10b

Invested Assets – Malaysia (as at December 2014)

(%)



Source: A.M. Best data and research

A key reason for the difference in the asset mix in the two markets is the underlying contrast in insurance portfolios. As noted above, Malaysian takaful operators derive the majority of their contributions from family takaful products, whilst Middle Eastern takaful portfolios are weighted towards general takaful. As a result, Malaysian life operators are likely to hold a larger portion of fixed-income/sukuk assets to match their longer-term liabilities. Additionally, given the relatively higher level of capitalization in the Middle East, a lower proportion of assets are required to back insurance liabilities, leaving a higher amount of capital available for more aggressive investment strategies.

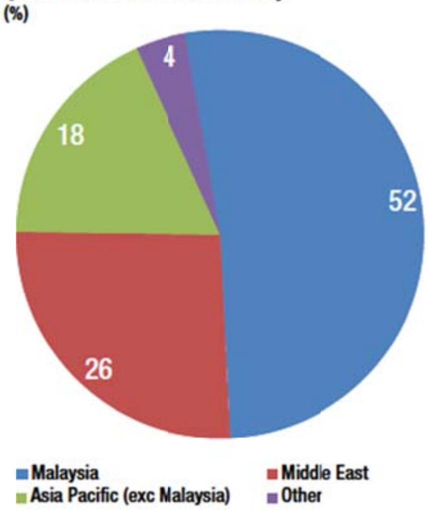
Middle Eastern takaful operators have significant investment concentrations in equity and real estate assets. This is due to the underdeveloped fixed income markets in the Middle East and potentially higher attractive returns achievable through investing in shares and property investments.
However, the issue of undeveloped fixed income markets is more acute within Islamic finance. Sukuk securities are heavily concentrated in Malaysia, with only a small amount of sukuks available in the Middle East, the vast majority of which are domiciled in Saudi Arabia.

A further issue is the small number of issuers in the Middle East region. A.M. Best believes that should a company seek to invest in sukuks, it would immediately face an issue with concentration risk. For example, 90% of the outstanding debt in Qatar is issued by the Qatar Central Bank. This problem is not only limited to the Middle East, as the majority of global sukuk is limited to three or four issuers (the biggest of which is the Malaysian Central Bank).

Exhibit 11

Middle East and Malaysia – Outstanding Sukuks by region (as at December 2015)

(%)



Sources: Bloomberg, RAM Rating Services Bhd, A.M. Best data and research

The contrasting investment strategies employed by operators in the two markets has a bearing on operating performance volatility. The risky equity and real estate assets in the Middle East can lead to significant fair value fluctuations being recognized in financial statements of local operators, which can cause volatility in the company's risk-adjusted capitalization. As a result, Middle East operators are required to hold an increased level of capital to absorb market value movements.