Global Takaful Insights 2013

Finding growth markets

EY
Building a better working world

Foreword

Welcome to our inaugural *Global Takaful Insights 2013*.

With the sustained expansion of the global takaful industry, EY is committed to continuing the development of its Islamic finance, "world takaful" thought leadership series.

Our new *Global Takaful Insights* aims to capture key Islamic insurance industry and regulatory developments across established and emerging markets and provide insights on the industry's growth and profitability, including opportunities and challenges. We will also outline some of the needs the industry has as it moves toward the next phase of its growth.

In recent years, the Islamic insurance industry experienced continued strong double-digit growth. In the challenging global economic climate, with its competitive market pressures, Saudi Arabia's cooperatives and other Gulf Cooperation Council (GCC) players are struggling to generate shareholder returns. Malaysia's takaful operators, however, fared better on their return on equity.

The external market challenges have spurred increasing operator focus on risk management and controls. Moving forward, various regulatory changes, including Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standard-setting, continue to evolve across markets and serve as platforms to encourage stronger industry governance, promote takaful business growth focus and expand the range of Shariah-compliant investments.

Meanwhile, it will be interesting to watch a new London initiative that aims to tackle the perennial problem of finding Shariah-compliant coverage for large commercial risks in the international subscription market.

In rapid growth markets, regulatory enhancements are opening new opportunities. The challenge is to build on the lessons learned from core Islamic finance markets to address latent, underlying market demand and to realize the takaful industry's optimum growth potential.

We hope you will derive useful insights from this report to support your business agenda.

Shaun Crawford
Global Insurance Leader

Ashar Nazim
Global Islamic Finance Leader

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Executive brief


Senior executives need to be clear with shareholders that significant changes in operating models and technology enablement are the only way to address the inflated, legacy start-up costs they are burdened with.

The success of the takaful industry over the past five years has seen sizable growth in gross written contributions (GWC). However, recent trends suggest an alarming deceleration of this young industry, from 22% (2007 to 2011 compound annual growth rate) to 16% in 2012.

The two biggest markets (Saudi Arabia and Malaysia) have considerably higher populations and GWC per operator — with profitability increasing through a combination of scale, risk diversification and improvements in claims and expense ratios. For Malaysia, a relatively developed Islamic finance industry including the development of the Sukuk market, has supported the growth of its takaful sector. Improved customer understanding and pricing could significantly enhance shareholder value for these operators in the future.

But this is where much of the good news concludes. Most other markets and smaller operators appear to be struggling. Our discussions with industry executives suggests that too many operators are pursuing an insufficient number of risks to increase their GWC. Not all will gain market share at the right price to be profitable — and those that do will struggle to satisfy what have been very patient shareholders. Senior executives need to be clear with shareholders that significant changes in operating models and technology enablement is the only way to address the inflated, legacy start-up costs they are burdened with.

Shareholders for their part need to have a clear strategy and capital plan with options ranging from organic and inorganic growth, maintaining and refining segmentation or exit or acquisition strategy.

And perhaps most importantly, authorities need to simplify regulatory framework across borders, as well as support development of larger, regional players. Regulators need to be watchful on how shareholder capital is being eroded. Some need to take a proactive approach to encourage consolidation where within a short time frame, minimum capital requirements will be breached due to ongoing underwriting losses.

Unless these issues are addressed as a matter of urgent priority, we believe the takaful industry will find it challenging to maintain its growth trajectory.

We hope that ***Global Takaful Insights 2013*** will be a key reference point as you assess your business structure and strategies.

Ashar Nazim
Global Islamic Finance Leader

Dato' Rauf Rashid
Country Managing Partner, Malaysia

Report findings

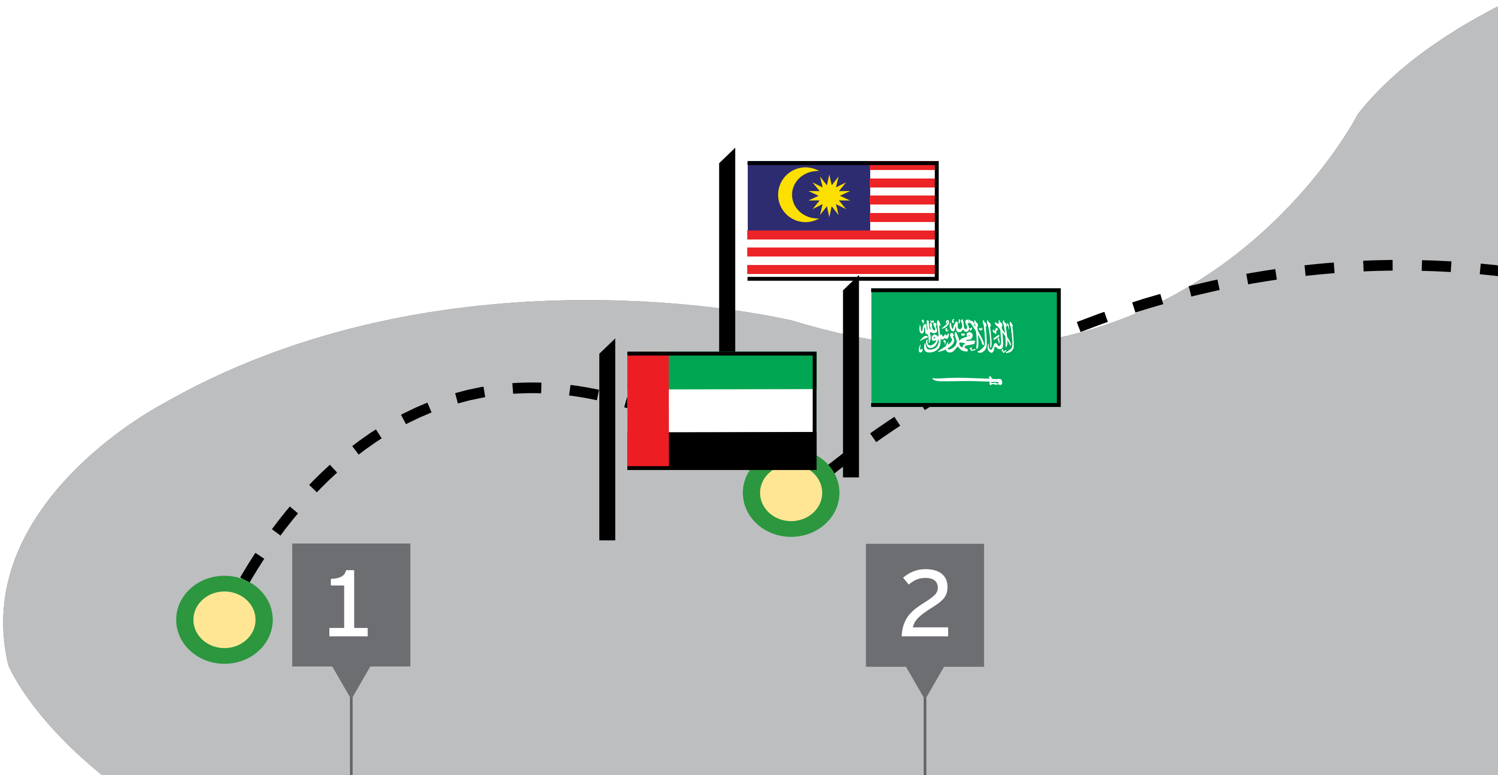
Report findings

Finding growth markets

Regional structural differences remain. Key markets continue to offer growth prospects with low market penetration rates, but wider opportunities beckon in emerging markets.

The Islamic insurance industry, or takaful in most markets, is still in its infancy. Its potential to replace conventional insurance in leading Islamic finance markets is untapped.

Despite significant regional differences, key markets that are largely underinsured continue to offer growth prospects; these include near developed and emerging rapid growth markets. Meanwhile, regulatory enhancements in rapid growth markets are presenting new opportunities in tapping latent underlying demand and propelling the takaful industry forward so the industry can realize its optimum growth potential.



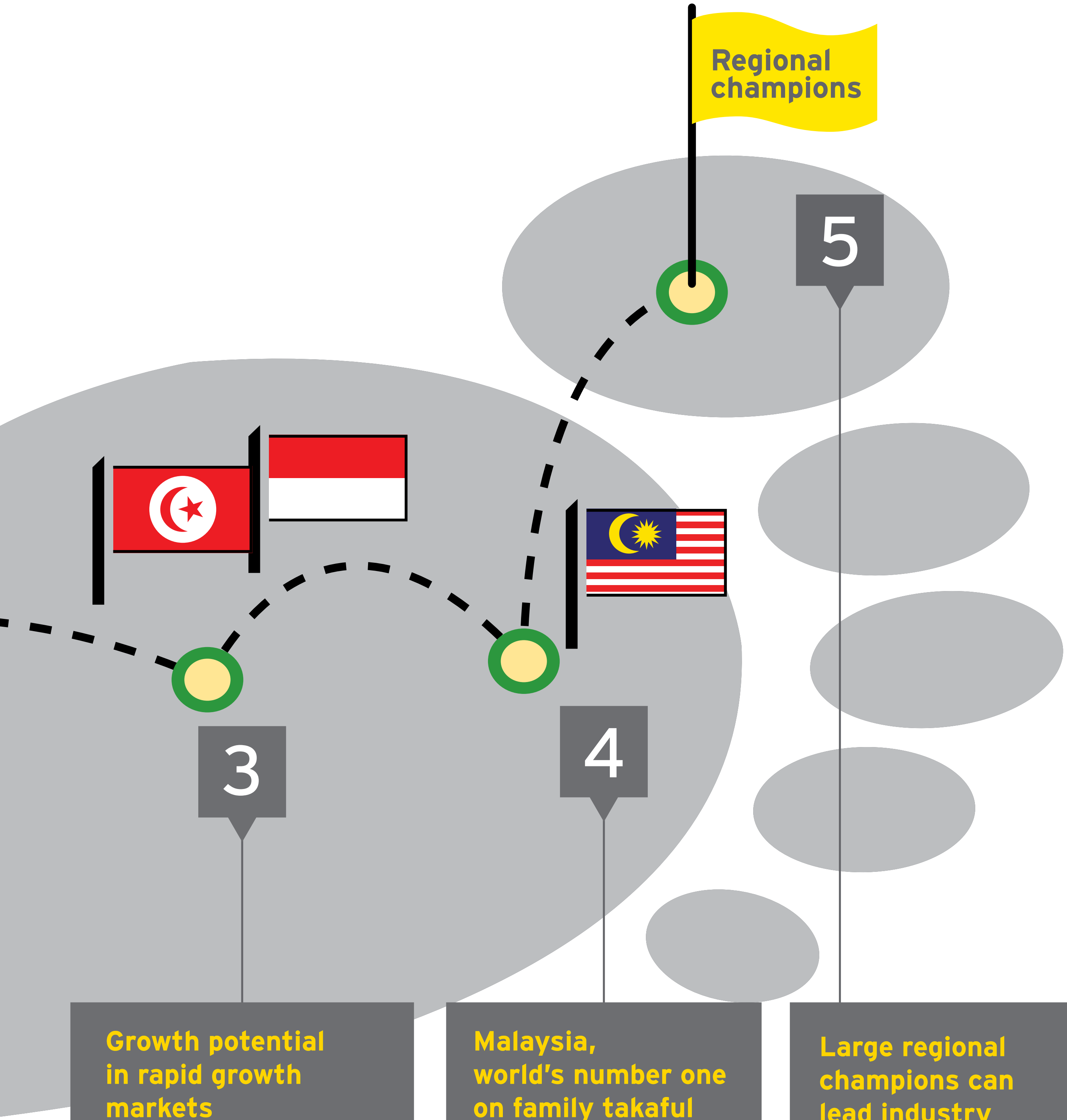
1. Varying markets, varying potentials

Growth and profitability prospects for takaful operators vary significantly by markets and sectors, depending on the market's economic maturity, industry and regulatory structure.

2. Growth ≠ profitability

Despite financial market volatility, there appears to be growth momentum in takaful's three key markets – Saudi Arabia, UAE and Malaysia. Acquisition of market share, however, has not necessarily translated to profitability in many instances.

Sources: EY analysis



Growth potential in rapid growth markets

Regulatory enhancements are presenting new opportunities in rapid growth markets such as Turkey and Indonesia. The challenge is to build on the lessons learned from core Islamic finance markets to expeditiously address rising demand.

Malaysia, world's number one on family takaful

Malaysia has emerged as the world's largest family takaful market. With a proven model and regulatory clarity, the country is set to further build on this leadership position.

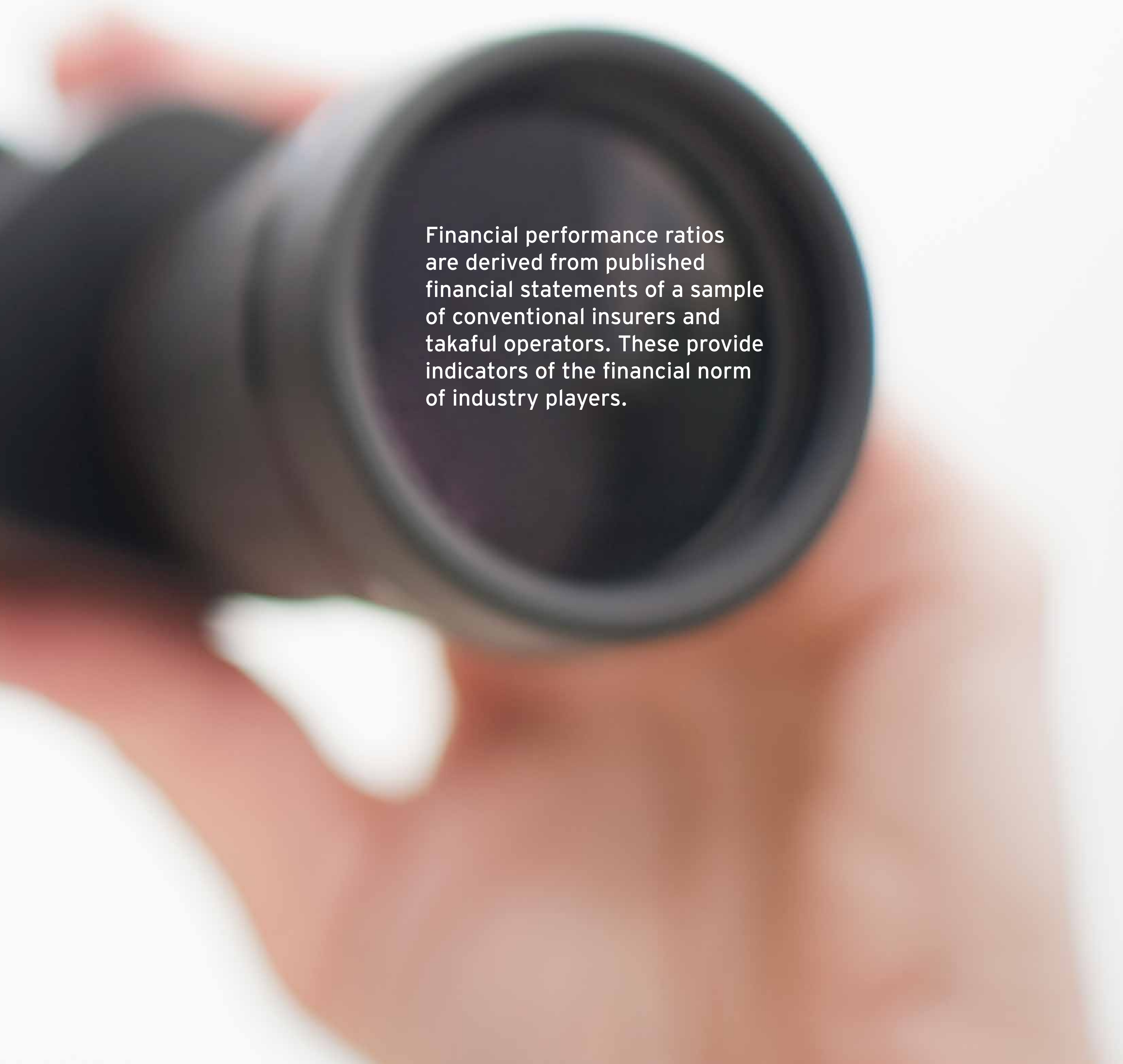
Large regional champions can lead industry

There is a dearth of takaful operators who are capable of providing leadership to the growing internationalization of the industry. There is a need for large, regional champions to lead growth in regional markets and to participate in international markets.

Saudi Arabia's insurers (including takaful) operate under a unique cooperative model. This differs from the pure takaful model of other countries.

Background

Global Takaful Insights 2013 is a refreshed version of EY's previous *World Takaful Report*, published since 2008.



Financial performance ratios are derived from published financial statements of a sample of conventional insurers and takaful operators. These provide indicators of the financial norm of industry players.

Key milestones in takaful, 2002–13

Year	EUROPE	GCC and MENA	ASIA
2002		**Lebanon** Takaful launched with the establishment of Al Aman Takaful	**Malaysia** Islamic Financial Services Board (IFSB) inaugurated
2003			**Pakistan** Takaful launched with the establishment of first takaful company - Pak Kuwait Takaful Limited
2005		**Saudi Arabia** Saudi Arabia Monetary Authority (SAMA) regulations for cooperative insurance supervision enacted **Bahrain** Bahrain Monetary Authority Rules including rules for takaful enacted	**Pakistan** Securities and Exchange Commission Pakistan (SECP) issued Takaful Rules
2006	**Germany** Hannover Re entered the retakaful industry **Switzerland** Swiss Re entered the retakaful industry		
2007	**Germany** Munich Re entered the retakaful industry		
2008	**Britain** Takaful launched with the establishment of Salaam Insurance		

This chart provides certain important events on the evolution of takaful and should not be construed to include all significant events.

Source: EY analysis

2009

Malaysia
IFSB-8 issued on takaful governance and IFSB-10 issued on Shariah governance principles

2010

Bahrain
AAOIFI Islamic insurance standard No. 26 issued

Malaysia
IFSB-11 issued on solvency for takaful

2011

Kenya
Takaful launched with the establishment of Takaful Insurance Africa

Saudi Arabia
SAMA directed all operators to align with the cooperative insurance model

2012

Qatar
Islamic finance windows in the QFC - Islamic Finance Amendment Rules 2012 - continues to allow takaful insurance by conventional firms

Pakistan
SECP drafted Takaful Rules 2012 allowing window takaful operations

Malaysia
Takaful Operating Framework launched

2013

Britain
Cobalt launched platform for writing large commercial risks (Shariah-compliant) – London market

Dubai
Rulers' vision unveiled – Dubai aspires to become the capital of global Islamic economy

Indonesia
Proposed new Act to phase-out takaful windows

Malaysia
Islamic Financial Services Act (IFSA) required the separation of family and general takaful into separate entities

Global events impacting takaful

The takaful industry has been challenged by political and economic events.

Saudi Arabia

Saudi Arabian Monetary Authority (SAMA) directed all operators to align with the cooperative insurance model by year-end 2011. Takaful operators had to adjust their internal accounting structures, remove the use of Wakala and Qard and amend product terms and conditions.

Saudi Arabia is a huge Islamic insurance market, and this shift away from the pure takaful model and regulatory harmonization has had a significant impact on the industry.

Middle East and North Africa (MENA)

The wave of uprisings sweeping across MENA is expected to have a major impact on the risk considerations of doing business and investing.

In particular, the Arab Spring has hindered the attractiveness of populous Muslim markets, such as Egypt, Sudan and Tunisia, for foreign investments. Previously, Libya and Egypt were considered high potential growth markets. With the prevailing risk situation in these countries, a number of projects have been postponed or curtailed.

UAE

In Dubai, the ruler's vision was unveiled for the emirate to aspire to become the "global capital" of the Islamic industry, economy and finance.

The wide-ranging initiative will include a Shariah council to oversee standards in Islamic finance, an arbitration center to resolve disputes in Islamic contracts and a drive to boost production of halal food within Dubai.

Turkey

Turkey is developing its regulations to allow issuers to use a variety of Shariah structures.

Association of Southeast Asian Nations (ASEAN)

Malaysia has recently announced the Islamic Financial Services Act (IFSA) 2013, which requires takaful operators to separate their life and general business and to have a minimum capital of RM100m (US$30.1m).

Moreover, new laws governing Malaysia's Islamic finance sector will boost protection for depositors by making religious advisers legally accountable for financial products, and liable to steep fines and imprisonment.

Indonesia is slowly emerging as a significant takaful market, overtaking several of the GCC countries in GWC.

Europe

The European crisis has dampened the prospects of takaful making gains at least in the near term. Increased solvency requirements add to the difficulty of launching takaful, given the risk structure of takaful and the favorable treatment of debt instruments in the capital adequacy calculation.

It may also limit the appetite of European insurers to invest overseas, as the new rules will apply at a group level as well as the insurer level.

However, an initiative has been launched in London to provide Shariah-compliant reinsurance to write large commercial risks. A subscription market is also needed to cater for such risks.

Industry activity: recent M&As in Asia

In recent years, we have witnessed a number of significant insurance deals across the Asia Pacific, including ASEAN countries. These deals have been inter-industry, including insurance companies, takaful companies, brokers and special purpose vehicles for holding groups. With supporting economic and demographic dynamics, the family takaful and medical takaful segments are likely to be future areas of M&A interest.

Table 1: Some of the recent M&As in Asia

Target country	Target	Acquirer's country	Acquirer	Year	Consideration (US$m)
China	Ping An Insurance	Thailand	Charoen Pokphand Group	2012	9,400
Hong Kong, Macau and Thailand	ING	Hong Kong	Pacific Century Group	2012	2,140
Indonesia	Asuransi Jaya Proteksi	Switzerland	ACE Group	2012	130
Indonesia	Panin Life	Japan	Dai-ichi Life Insurance	2013	337
Indonesia	Global Asistensi Manajemen Indonesia (GAMI)	Indonesia (UK parent)	Jardine Lloyd Thompson	2013	NP
Indonesia	GESA Asistance	Indonesia (UK parent)	Jardine Lloyd Thompson	2013	NP
Indonesia	Central Sejahtera Insurance	Indonesia	Bank Central Asia	2013	NP
Malaysia	ING and ING Public Takaful Ehsan	Hong Kong	AIA Group	2012	1,730
Malaysia	CIMB Aviva Assurance and CIMB Aviva Takaful	Canada and Malaysia	Sun Life Financial and Khazanah Nasional	2013	600
Malaysia	Uni.Asia Life Assurance	USA	Prudential Financial Inc.	2013	160
Malaysia	Pacific & Orient Insurance	South Africa	Sanlam	2013	89
Malaysia	Insfield Insurance Brokers	Malaysia (UK parent)	Jardine Lloyd Thompson	2013	NP
Thailand	Thanachart Life Assurance	Thailand (UK parent)	Prudential	2012	585
Thailand	Thai Life Insurance	Japan	Meiji Yasuda Life Insurance	2013	700
Malaysia	AmLife Insurance and AmFamily Takaful	Various	Various	2013	NP

NP = Not published

Sources: Various sources, EY analysis

Industry activity: recent M&As in MENA

The pace of M&A within the takaful segment lags behind the conventional insurance industry. However, as investor sentiments evolve — and the industry battles to differentiate and survive — we are likely to see increasing mergers, divestments and acquisitions.

Table 2: Some of the recent M&As in MENA

Target country	Target	Acquirer's country	Acquirer	Year	Consideration (US$m)
Bahrain	MEDGULF	Japan	ORIX Corporation	2013	200
Qatar	Qatar Insurance Company	Qatar	Qatar Holding	2013	265
Saudi Arabia	MEDGULF	Lebanon	Lutfi El-Zein Group	2011	400
Saudi Arabia	MEDGULF	US	International Finance Corp.	2012	124
Turkey	Dubai Group Sigorta	UAE	Oman Insurance Company	2012	NP
Turkey	Acibadem Sigorta (Health insurance)	Malaysia	Avicennia Capital (Khazanah Nasional)	2013	252
UAE	NAS United Healthcare Services	UAE	HSBC Private Equity Middle East	2012	NP
UAE	Takaful Emarat Insurance	UAE	Al Soor Investment	2013	NP

NP = Not published

Sources:
Various sources;
EY analysis

"The MENA region has seen capital raising activity through IPO's and rights issues in addition to the M&A transactions above. In several cases, companies have used existing capital to support transaction requirements without the need to raise new capital or materially impacting their net position."

\- Justin Balcombe

Industry performance and outlook

Global takaful contributions

A US$11b industry (2012), still growing at 16% per annum

Global gross takaful contributions are estimated to reach US$11b in 2012 (from US$9.4b in 2011). Saudi cooperatives account for approximately 51% of the global contributions.

Year-on-year growth has slowed from the 2007–11 CAGR of 22% to a more sustainable growth rate of 16%. Although growth potential is high, the various strategic and political issues are dampening the opportunities at large.

The silver lining of the industry is the development of the family takaful sector, which continues to show positive growth momentum particularly in ASEAN markets.

Chart 1: Global gross takaful contributions by region, 2007–12f[1]

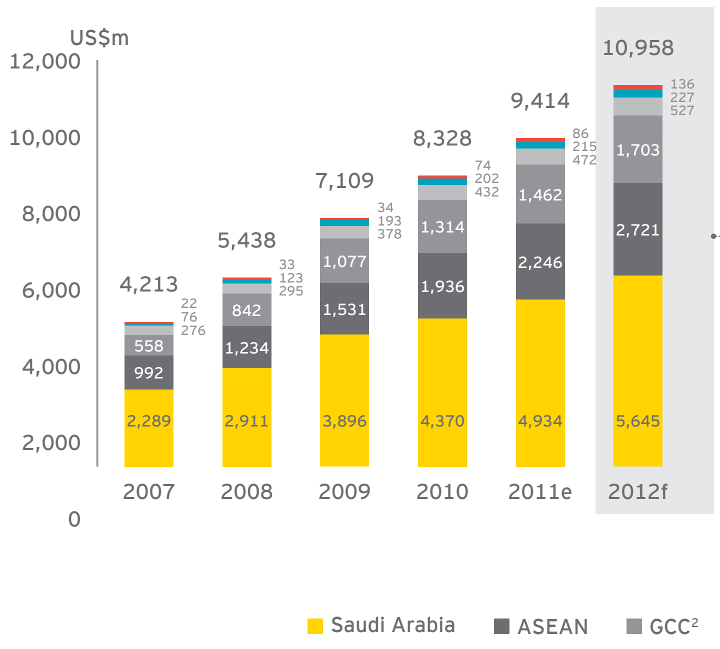
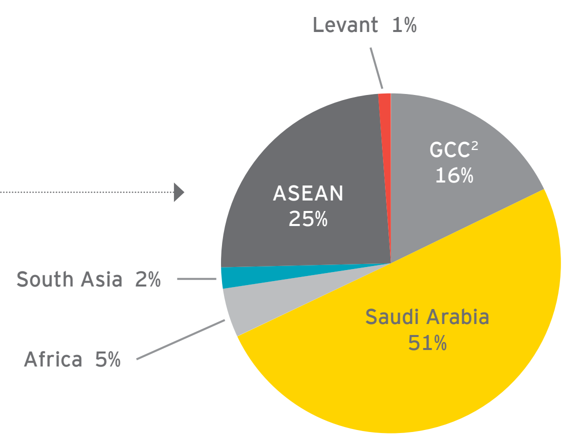


Chart 2: Share of global gross takaful contributions by region, 2012f



[1]World excluding Iran

[2]GCC countries included are Bahrain, Kuwait, Qatar and UAE, excluding Saudi Arabia

- Data for Bahrain, Indonesia, Malaysia, Qatar and Saudi Arabia has been cross-checked with other secondary sources. Data for Malaysia is net takaful contributions.

Sources:
World Islamic Insurance Directory 2013, Middle East Insurance Review; EY analysis

GCC takaful contributions

Leading GCC markets are propelled by their respective countries' compulsory National Health Insurance policy.

In recent years, the GCC region (including Saudi Arabia) continued to record stable industry growth with buoyant performance in some countries.

The growth lever for strong growth in Saudi Arabia and UAE (specifically Abu Dhabi) was the implementation of the compulsory National Health Insurance policy. Qatar has followed on the heels of regulatory compulsion, and the implementation of its National Health Insurance policy will drive demand of its takaful industry.

Chart 3: GCC gross takaful contributions by country, 2007–12f

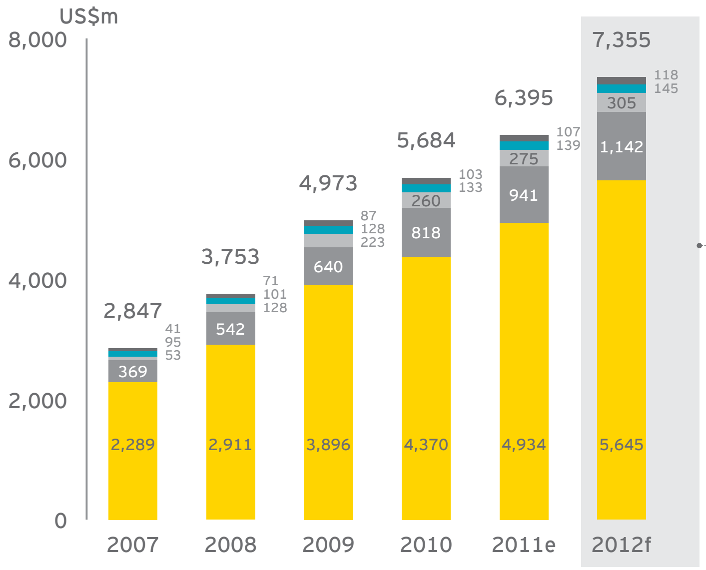
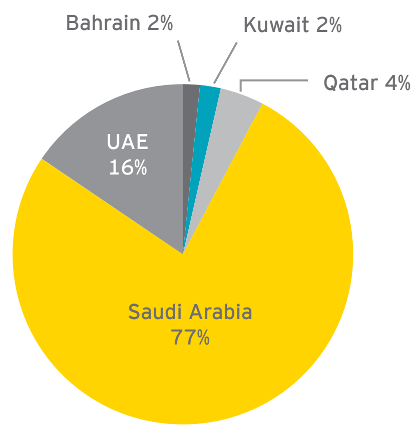


Chart 4: Share of GCC gross takaful contributions by country, 2012f



Sources:
World Islamic Insurance Directory 2013, Middle East Insurance Review; EY analysis

ASEAN takaful contributions

Malaysia leads in takaful market contributions, while Indonesia is catching up with rapid growth expansion.

ASEAN takaful growth was powering at 22% CAGR from 2007 to 2012, driven by the strong economic dynamics in Asia Pacific and its positive impact on domestic economies.

Malaysia currently holds a 71% share of ASEAN takaful contributions. In 2012, Malaysia's takaful industry grew strongly by 21%. In the same year, the Indonesian takaful industry also experienced strong growth at 26%, although from a lower base.

Chart 5: Selected ASEAN countries' gross takaful contributions, 2007–12f

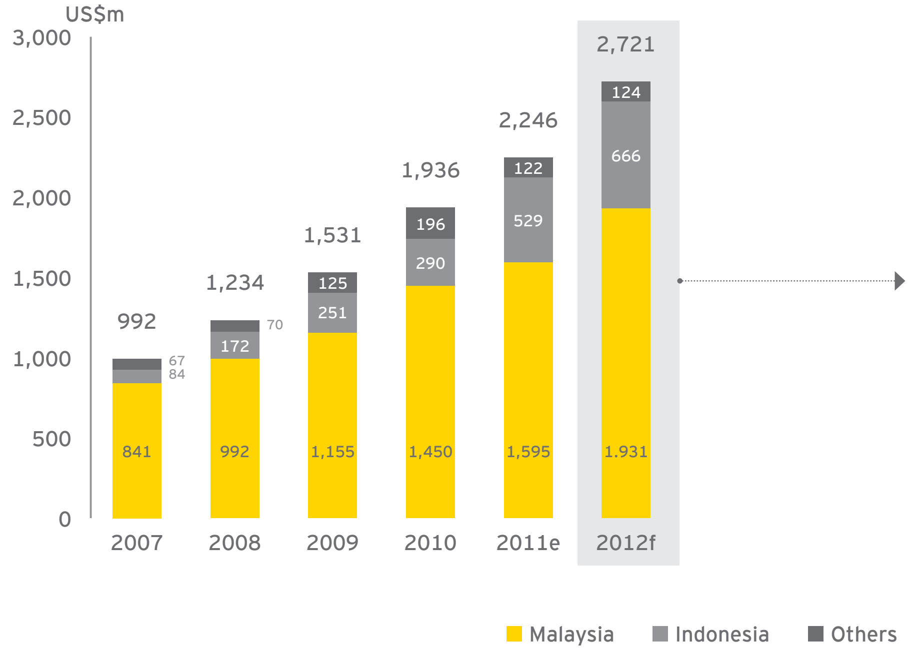
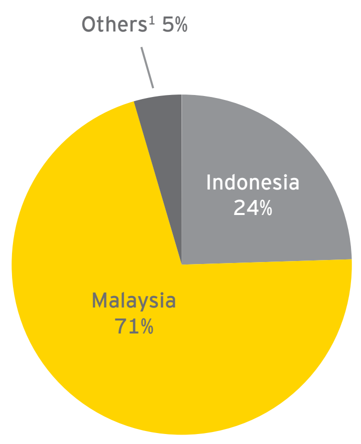


Chart 6: Share of selected ASEAN countries' gross takaful contributions, 2012f

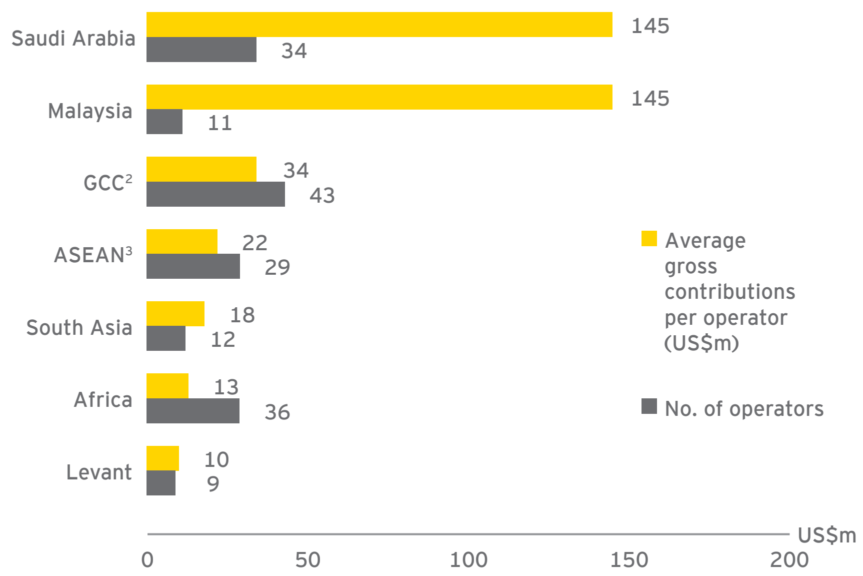


[1]Others includes Brunei, Singapore and Thailand

Sources:
World Islamic Insurance Directory 2013, Middle East Insurance Review;
EY analysis

Takaful market centers and business segments

Chart 7: Key takaful market centers[1]



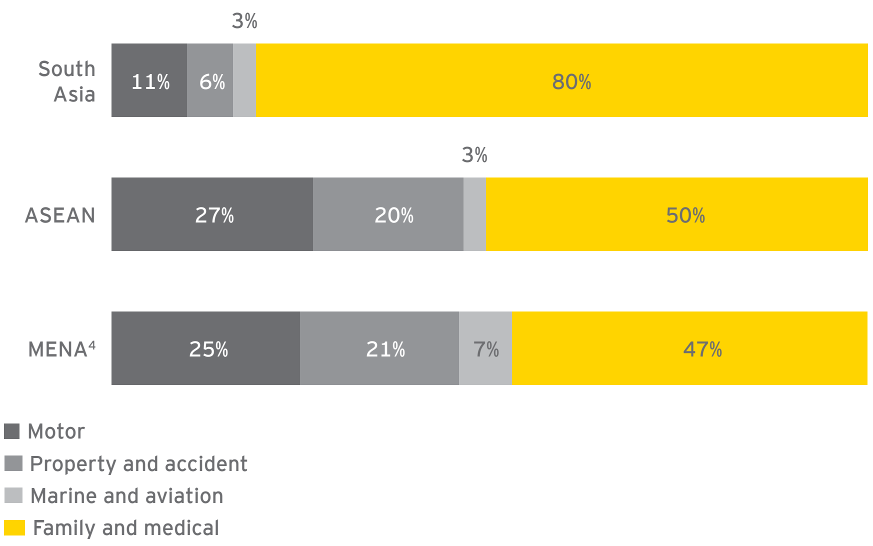
Except for Saudi Arabia and Malaysia, most operators in other markets lack scale.

[1]Data in 2011e
[2]GCC excluding Saudi Arabia
[3]ASEAN excluding Malaysia

Sources:
World Islamic Insurance Directory 2013, Middle East Insurance Review;
Annual Takaful Statistics 2011, BNM;
The Saudi Insurance Market Report 2011, SAMA;
EY analysis

Family and medical takaful are the major business lines across all markets.

Chart 8: Key takaful business lines in major markets[1]



[4]MENA includes GCC, Levant and North African countries.

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

Global takaful forecast

The growth of the takaful industry will ride on the recovery of the global economy — prospects appear modest.

In the foreseeable future, achieving a unified approach to a consistent regulatory framework across takaful markets is challenging.

Therefore, takaful operators need to adopt a business as usual approach and transform or refocus on risk specialization, underwriting discipline and strategizing on the growth of the Islamic capital markets.

In the near to medium term, traditional growth markets, including Saudi Arabia, UAE and Malaysia, continue to ride on favorable market conditions and a young demographics structure.

Over the longer term, takaful opportunities lie in large rapid growth markets such as Indonesia and Turkey. Their favorable demographics will provide for a strong family takaful play.

Chart 9: Global takaful contributions forecast, 2009-15f[1]

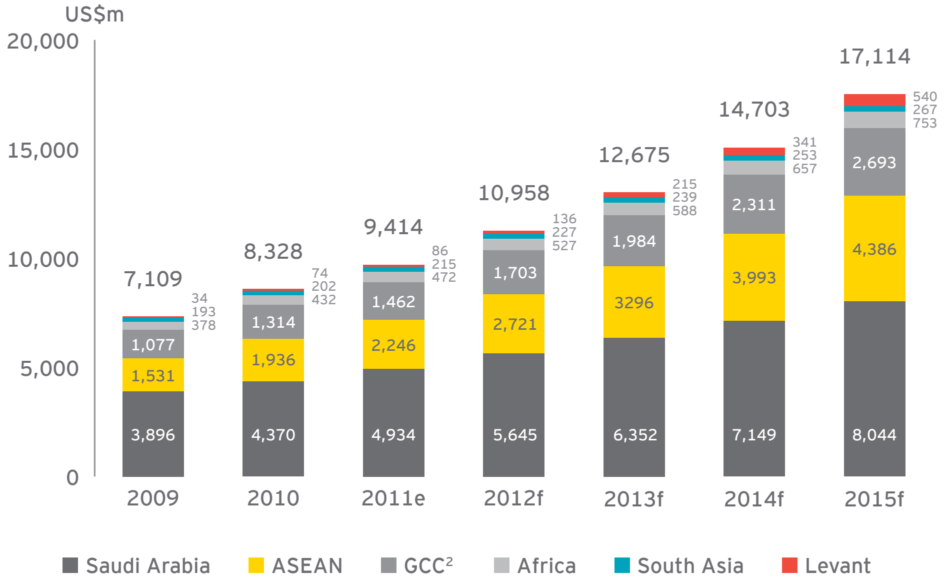
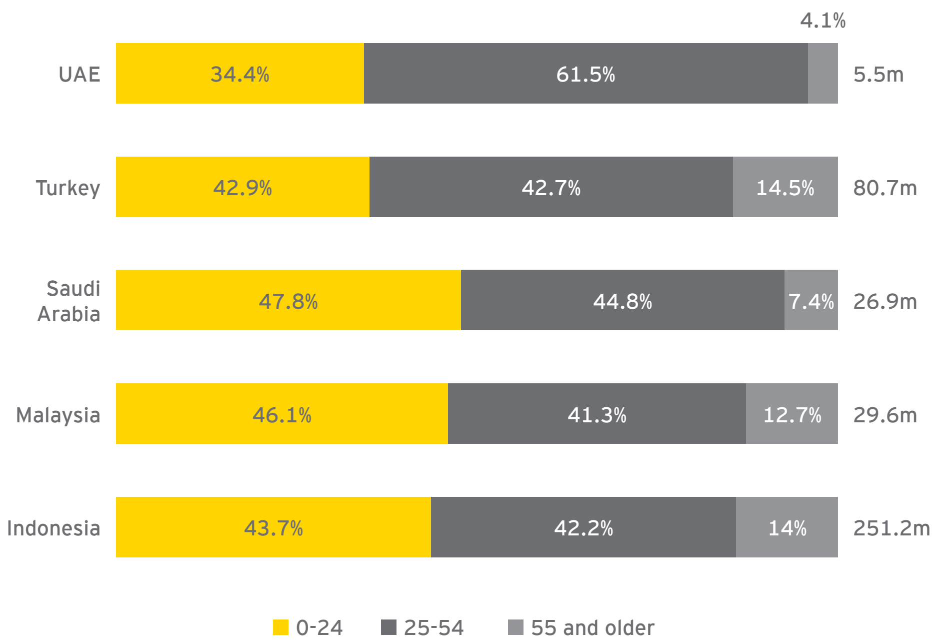


Chart 10: Population breakdown by age group, 2013e



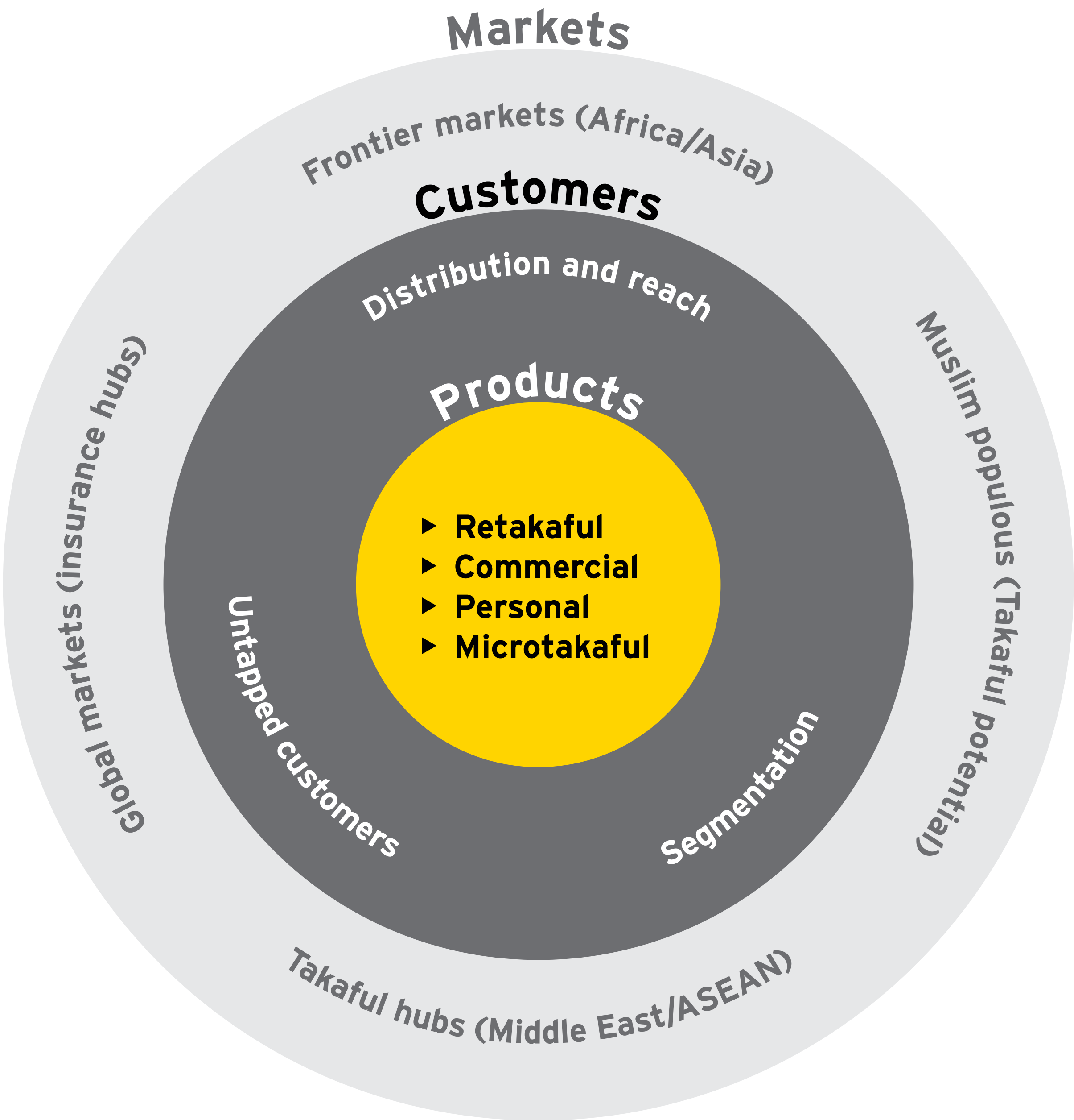
[1]World excluding Iran
[2]GCC excluding Saudi Arabia

- Forecast is based on respective CAGR between 2009 to 2011, adjusted for emerging trends.

Source:
World Factbook, CIA;
World Islamic Insurance Directory 2013,
Middle East Insurance Review;
EY analysis

The untapped potential of takaful

The takaful industry is largely concentrated in specific markets and in limited segments and business lines. This suggests future opportunities to explore latent markets.



Source:
EY analysis

Markets

Global markets (insurance hubs)

- Takaful operators should do more to attract customers from the conventional insurance market across different product lines.

Takaful hubs (Middle East/ASEAN)

- Greater penetration is necessary in the core takaful hubs to at least achieve the same market share as Islamic banking.
- Pioneers also need to size up and strengthen their regional presence and customer base.

Muslim populous countries

- Regulatory initiatives and the launch of takaful operators in the key populous markets of Turkey, Commonwealth of Independent States (CIS) countries, Russia, India and China, will spur the next wave of growth.

Frontier markets (Africa/Asia)

- The establishment of separate regulatory transparencies for takaful will accelerate growth in these markets. Technical and financial assistance will come from Islamic Development Bank and other facilitating organizations.

Customers

Distribution and reach

- Technology enablement will be a key driver for engaging with new customers as well as reducing operational costs. Banking has led the way with alternative channels and takaful operators can replicate their success to achieve scale quickly and efficiently.
- The channel mix must include branch, telephone, online, direct sales force, mobile, bancatakaful and partnerships.

Segmentation

- Many takaful operators continue to offer a one-size-fits-all proposition. Detailed analysis of customers' needs are required to match target customers with a better suited proposition. This will also enable operators to match products with customers in the right channels.

Untapped customers

- Operators need to be more innovative in reaching their target customers. A segmentation model will help identify which customers (risks) the client has and those to target. On this basis, acquisition strategies can be developed using the right mix of products, channels and marketing.

Products

Retakaful

- Retakaful capacity could resurface as an issue if the industry growth continues at the current or accelerated rate. Large retakaful operators should include retrotakaful options in their plans to provide necessary cover for mega risks across multiple retakaful operators.

Commercial lines

- Distribution remains a limiting factor, but partnerships with banks and large brokers will address this.

Personal lines

- Detailed analysis of customer needs is required to develop new product propositions beyond the vanilla "one-size-fits-all" options prevalent in the marketplace.

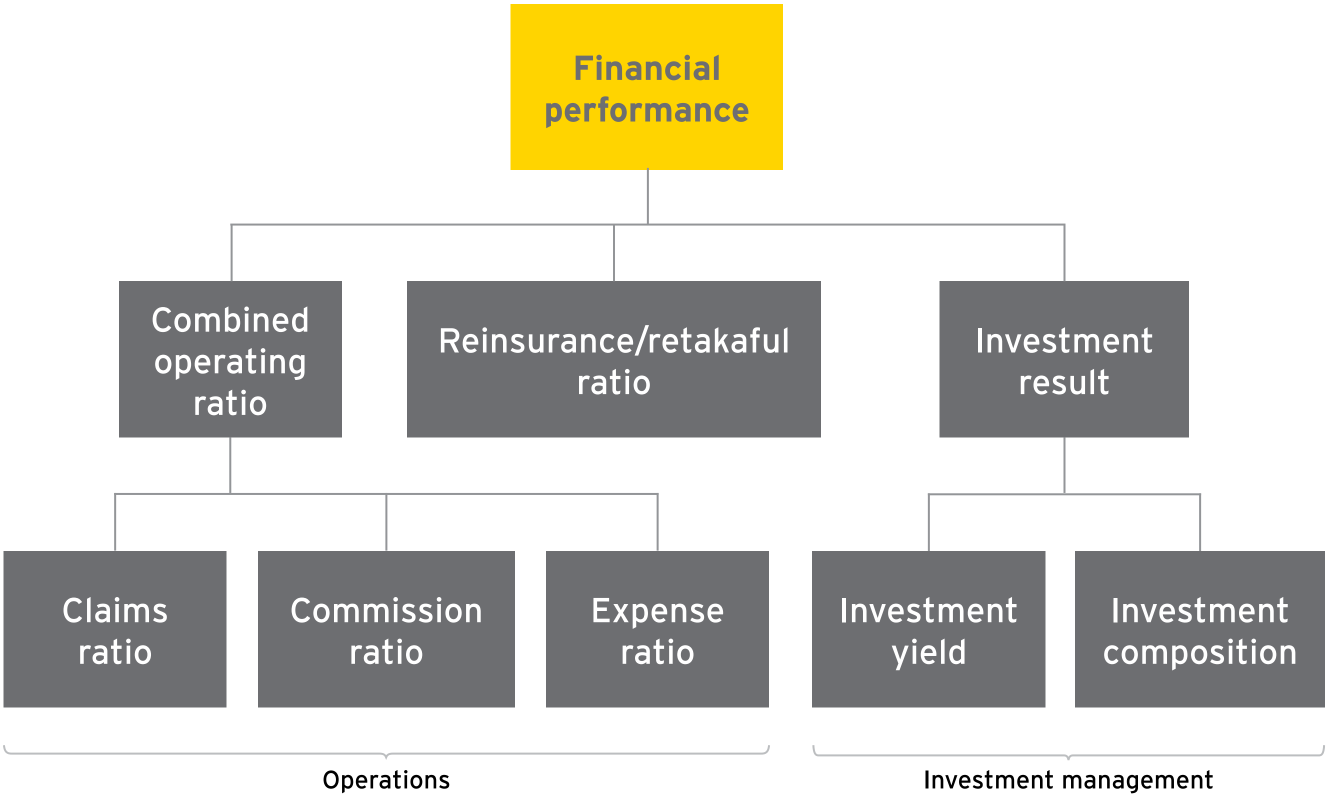
Microtakaful

- With the large low income and lower-middle income segments that characterize most Muslim populated countries, microtakaful products can be tapped.

Financial performance

Financial performance

From a sample collation of the financial statements of takaful operators across key markets, we have segmented our analysis into two parts: the insurance operations and investment management.



When analysing financial indicators, it is important to understand the underlying principles of the various takaful models.

- Data used for the analysis is based on financial statements between 2010 and 2012 from a sample of takaful operators, cooperative insurers and conventional insurers covering the GCC (Bahrain, Kuwait, Qatar, Saudi Arabia and United Arab Emirates) and Malaysia.
- Ratios reported in this report may differ from previous WTR analysis as sample size has been enhanced.
- Refer to research methodology in Appendices for sample breakdown.

Across key markets, significant improvements were noted in the combined operating ratio — largely attributed to a lower expense ratio.

Table 3: Snapshot of financial performance, 2012

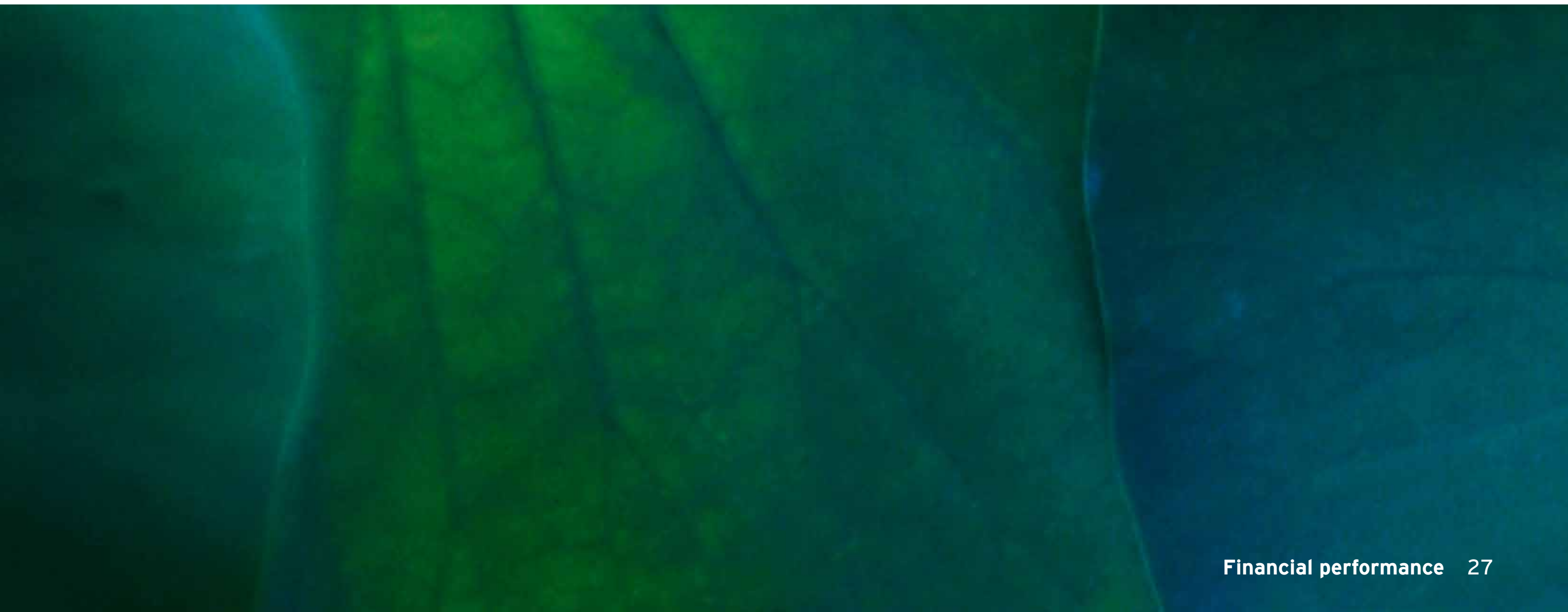
Key ratios (%, 2012)	GCC (excluding Saudi Arabia)	Saudi Arabia[1]	Malaysia[2]
Claims ratio	64	69	62
Commission ratio	4	3	13
Expense ratio	38	23	24
Combined operating ratio	106	95	99
Investment yield	6	3	5
Return on equity	0.4	4	13

[1]Saudi Arabia's insurers (including takaful) operate under a unique cooperative model — this model is different than other countries' pure takaful model.

[2]Malaysia's takaful sector derives nearly 78% of its net contributions from the family takaful business.

- Financial performance ratios are derived from published financial statements of a sample of conventional insurers and takaful operators. These provide indicators of the financial norm of industry players.

Source:
EY analysis



Managing financial issues

Financial performance remains a challenge for takaful operators in many markets.

Key strategic issues

Efficiency in operation

- Most takaful operators have yet to achieve critical business volume despite incurring substantial establishment costs over formative years.
- Takaful expense ratio remains higher than conventional peers.
- Distribution capabilities, along with service quality, remain key challenges to better performance for takaful operators.
- Shareholder expectations of return may be generally misaligned comparing takaful and conventional business models.

Quality of underwritten business

- Most takaful operators are start-ups or small players, limiting their access to quality customers, which negatively impacts their claims ratios.
- There is a concentration of business in the retail segment. Access to potentially lucrative commercial lines is limited due to underdeveloped broker relationships, operational history and scale.
- Complex risks are not well understood and potentially mispriced.

Solvency and capital requirements

- Stricter solvency and capital requirements will make it harder for smaller players to be competitive. Young takaful players will need to either quickly build scale or consider mergers to meet these requirements.
- The result of having better capitalized companies may impact shareholder profitability and returns in the short to medium term.

Growth ≠ profitability

Despite financial market volatility, there appears to be growth momentum in takaful's three key markets — Saudi Arabia, UAE and Malaysia. Acquisition of market share, however, has not necessarily translated to profitability in many instances.

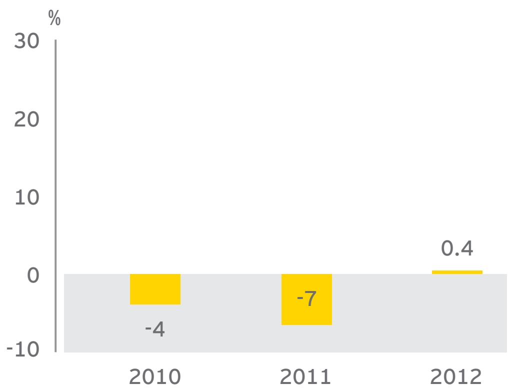
Source:
EY analysis

Average return on equity
(Before tax and other mandatory contributions)

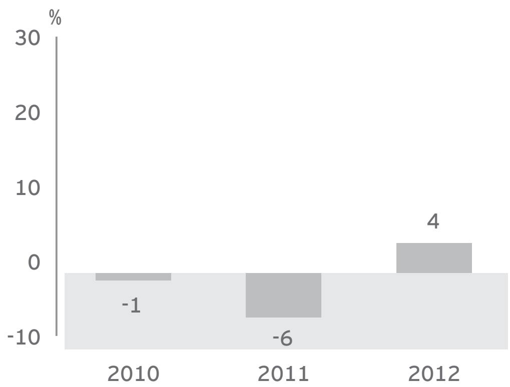
Across key markets, 2012 takaful return on equity (ROE) has improved over 2011.

Chart 11: Average return on equity

GCC sample (excluding Saudi Arabia)

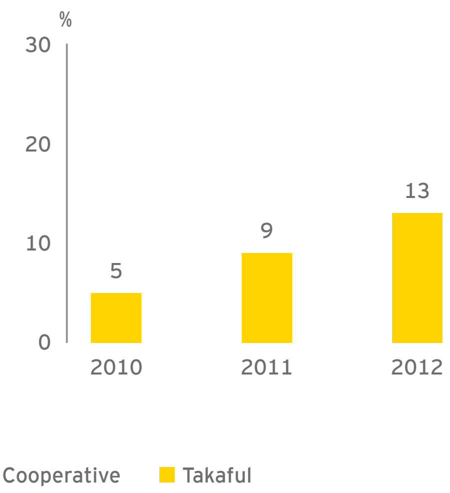


Saudi Arabia sample



- The ROE of Saudi cooperatives and other GCC takaful players is improving despite their struggle for profitability.
- Malaysia-based takaful operators generally have higher ROE than their GCC peers.

Malaysia sample



- Return on equity = Profit/surplus before tax and/or zakat attributed to shareholders, divided by total shareholders' equity
- Profit/surplus before tax and/or zakat is used to eliminate tax exposure differences across countries and regions in order to allow a fairer comparison between them.

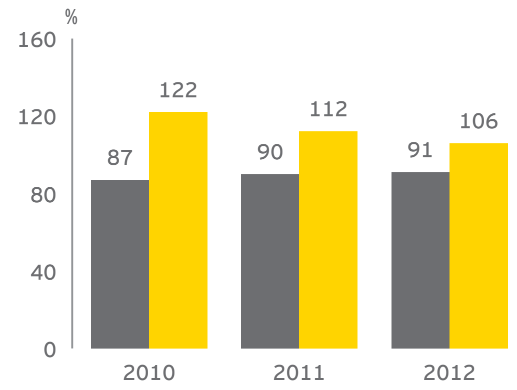
Sources:
Companies' financial statements 2010–12, EY analysis

Average combined operating ratio

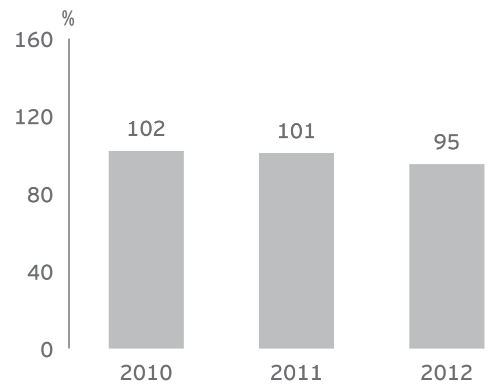
Takaful combined operating ratio (COR) is improving largely due to a lower expense ratio.

Chart 12: Average combined operating ratio

GCC sample (excluding Saudi Arabia)

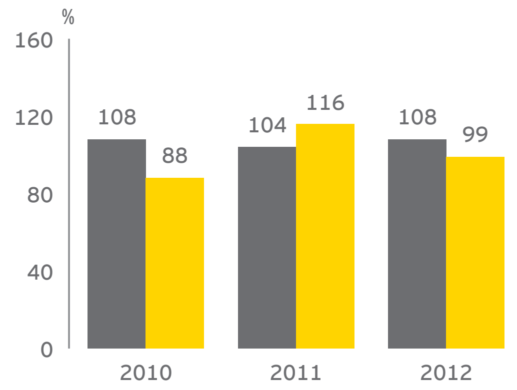


Saudi Arabia sample



- Across key markets, COR is improving with lower expense ratios.
- However, in 2011, Malaysia's takaful operators' COR rose to 116%, higher than conventional insurers (104%) as a result of increased expenses and aggressive pricing.

Malaysia sample



Conventional Cooperative Takaful

- Combined operating ratio = claims ratio + commission ratio + expense ratio

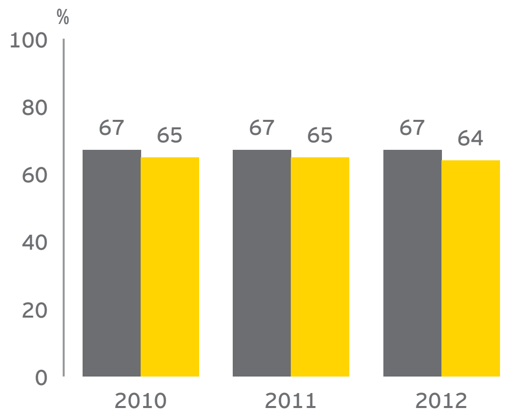
Sources:
Companies' financial statements 2010-12, EY analysis

Average claims ratio

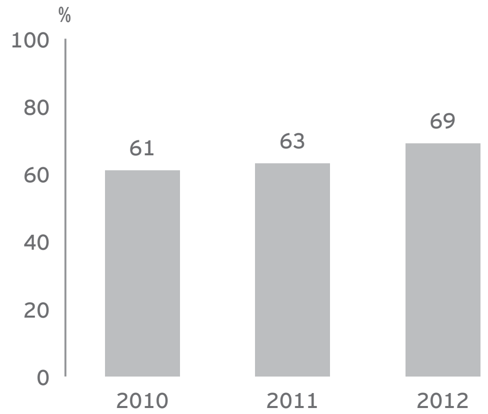
Except for Saudi Arabia, the average claims ratio for Malaysia and GCC countries is improving.

Chart 13: Average claims ratio

GCC sample (excluding Saudi Arabia)

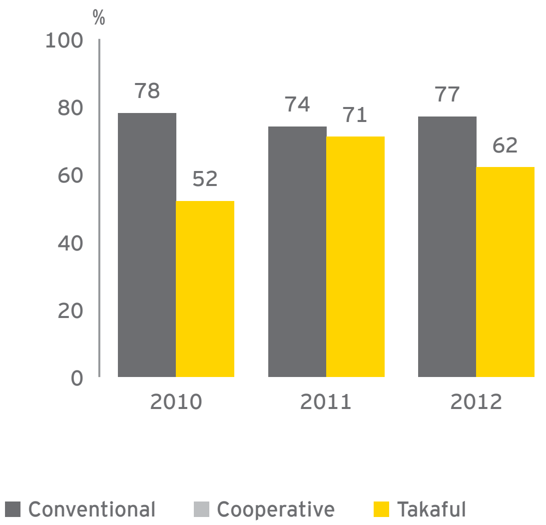


Saudi Arabia sample



- In Malaysia, the gap in claims ratio between conventional insurers and takaful operators has widened in 2012. However, this may reflect the fact that conventional insurers have a higher proportion of matured life policies, resulting in a higher claims ratio.
- In Saudi Arabia, the claims ratio has been deteriorating over the last three years mainly due to increasing claims from the motor and health insurance businesses. In 2012, the property or fire insurance business recorded a hike of nearly 47% in claims paid.
- Over the last three years, the GCC (excluding Saudi Arabia) claims ratio of takaful operators has been stable at 64-65%.

Malaysia sample



- Claims ratio = net benefits and claims incurred, divided by net earned premiums/contributions

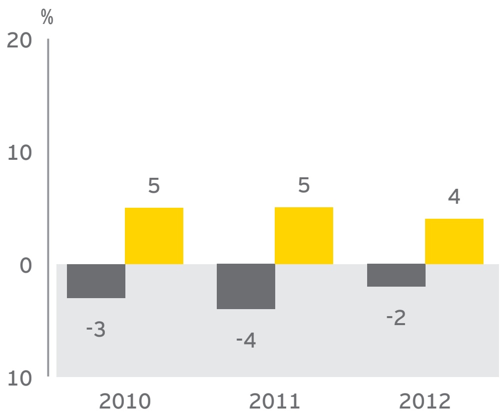
Sources:
The Saudi Insurance Market Report 2012, SAMA;
Companies' financial statements 2010–12;
EY analysis

Average commission ratio

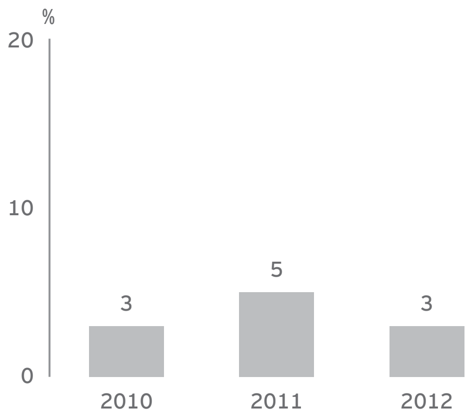
Despite prevailing competition, the average commission ratio remains stable.

Chart 14: Average commission ratio

GCC sample (excluding Saudi Arabia)

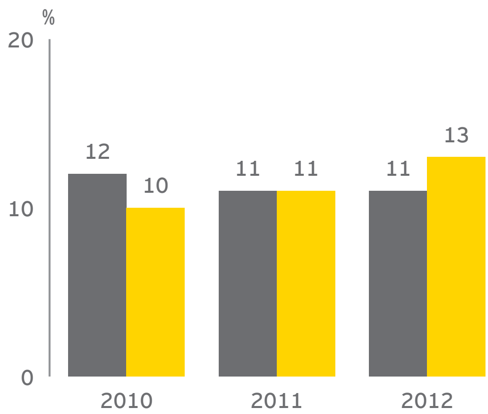


Saudi Arabia sample



- Conventional insurers continue to have a competitive advantage in the GCC market where their scale allows them to pay lower commissions and retain more risk without the need to cede to re-insurers.
- In 2012, Malaysian takaful operators had a higher ratio than conventional operators, possibly as a result of increasing competition from the entry of new takaful operators post-2010.

Malaysia sample



Conventional Cooperative Takaful

- Commission ratio = net commission paid, divided by net earned premiums/contributions

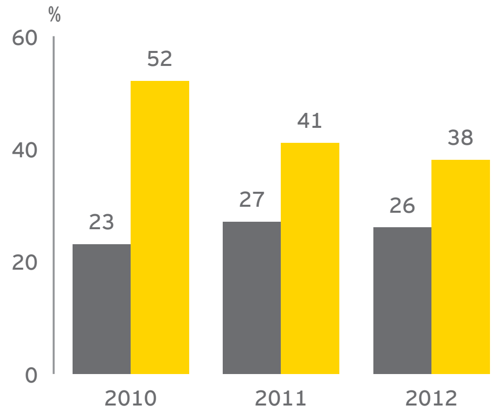
Sources:
Companies' financial statements 2010–12, EY analysis

Average expense ratio

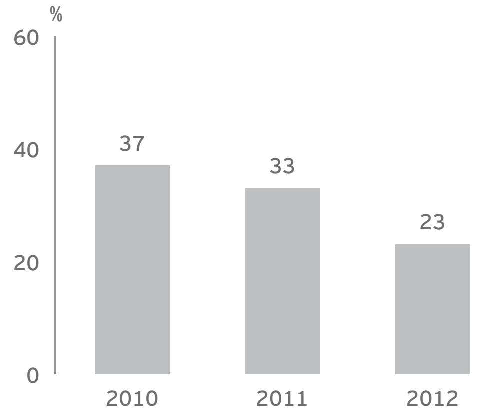
The average takaful expense ratio has declined in 2012 across key markets.

Chart 15: Average expense ratio

GCC sample (excluding Saudi Arabia)

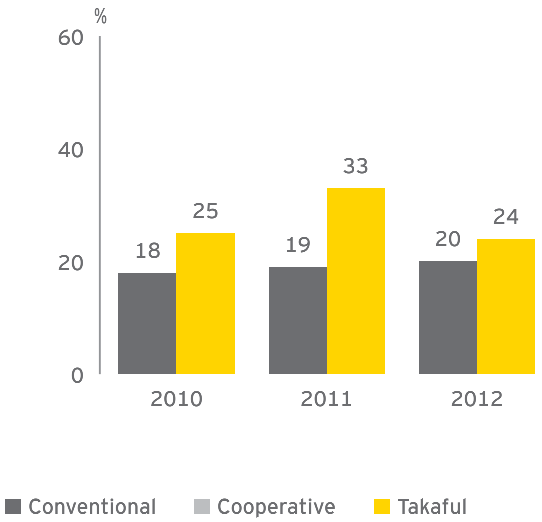


Saudi Arabia sample



- The average expense ratio of takaful operators in GCC countries and Malaysia is narrowing, although it remains higher than their conventional peers.
- Cost-control is a challenge for takaful operators because of their lack of scale compared to conventional players.
- Less established operators, particularly those with less than eight years of operations experience, remain straddled with legacy business plans and implementation that impacts operational efficiency.

Malaysia sample



- Expense ratio = total general and administrative expense, divided by net earned premiums/contributions

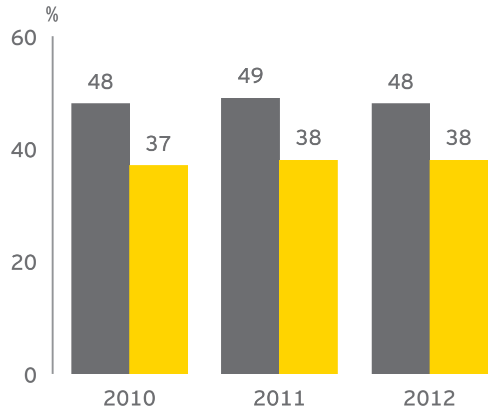
Sources:
Companies' financial statements 2010–12, EY analysis

Average reinsurance ratio

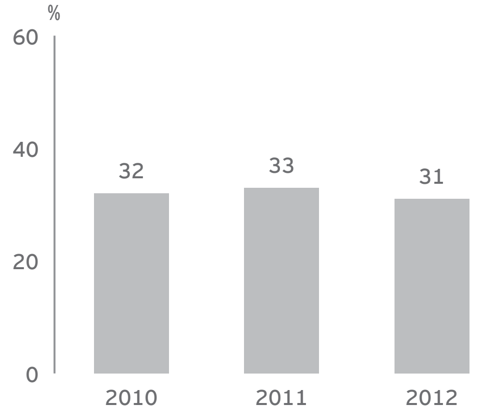
In contrast to Malaysia, both GCC takaful operators and Saudi cooperative insurers cede a higher proportion of their insurance underwriting business to reinsurers.

Chart 16: Average reinsurance ratio

GCC sample (excluding Saudi Arabia)

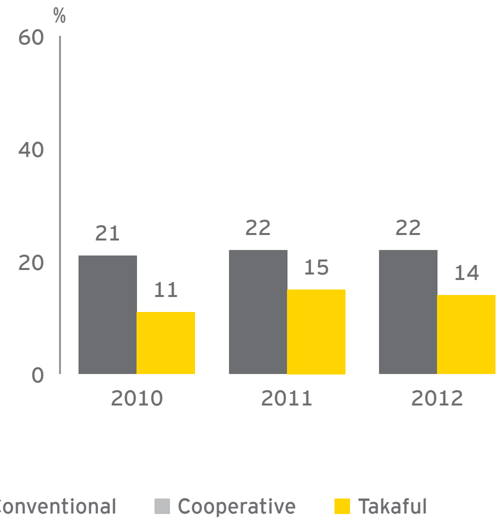


Saudi Arabia sample



- Malaysia's takaful business is highly focused on the lower risk family takaful segment (about 78%), in comparison to GCC which has a higher proportion of general takaful business.
- GCC and Saudi Arabia write relatively more general insurance, which is more volatile and needs reinsurance cover.

Malaysia sample



- Reinsurance ratio = gross written contributions ceded to reinsurance/retakaful, divided by gross written premiums/contributions

Sources:
Companies' financial statements 2010-12,
EY analysis

Average investment yield

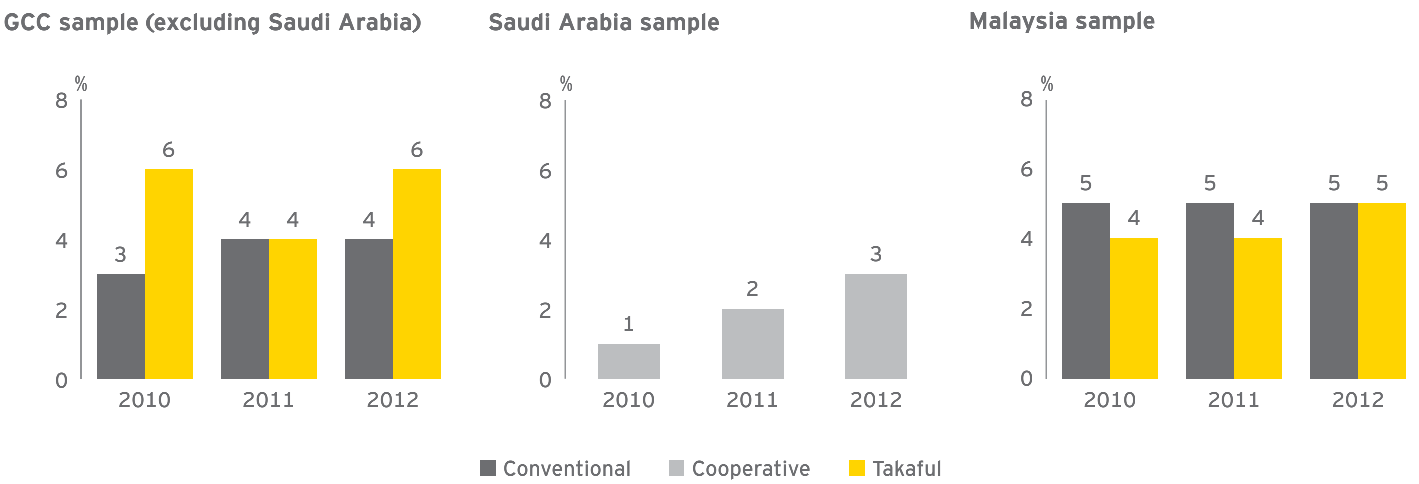
Investment yield for takaful operators and conventional insurers in GCC and Malaysia is on average in the 4% to 5% range.

The investment returns for Saudi Arabia cooperatives are improving, but remain comparatively low. Elsewhere in the GCC, takaful has actually outperformed the conventional sector in two of the last three years.

- Investment yield = total investment income, divided by total investment

Sources:
Companies' financial statements 2010–12,
EY analysis

Chart 17: Average investment yield



Investment composition

Three distinct markets with varying investment risk appetites

While GCC takaful operators have 25% of their investment in equities, Malaysia's takaful operators have nearly 60% of their investment in Sukuks. Saudi Arabia's cooperative insurers and GCC takaful operators rely heavily on investment in deposits.

Investment in halal instruments is often a challenge for takaful operators. Malaysia's greater use of Sukuks and deposits is due to its higher focus on family takaful.

Table 4: Investment composition

Average share of investment %, 2010–12	**GCC** (excluding Saudi Arabia)	**Saudi Arabia**	**Malaysia**
Equity	25	7	11
Sukuk	2	22	58
Deposit	41	44	23
Other investments[1]	32	26	9
Total[2]	100	100	100

[1]Other investments consist mainly of:
- For Malaysia: investment in unit trusts as well as in real estate, etc.
- For Saudi Arabia: investment in funds related to savings products as well as loans, real estate, etc.
- For GCC (excluding Saudi Arabia): investment in real estates and managed funds, etc.

[2]Numbers may not add up due to rounding.

Sources:
The Saudi Insurance Market Reports, 2010-2012, SAMA;
Companies' financial statements 2010–12;
EY analysis

Strategizing to be a regional champion

A key ingredient needed to grow a successful industry is the establishment of a large regional or global player whom all other participants aim to take market share from. The insurance industry has a number of global dominant players: AIG, Prudential, Aviva and RSA to name a few. However, there are few takaful companies who can make claims to be regional. As for a truly global takaful MNC, this remains a vision rather than reality.

The benefits of scale are more than the leveraging of fixed costs. They include:

- Diversifying across risk profiles with a wider range of products
- Ceding less business to retakaful companies
- Participating in retakaful activities with smaller operators

Any strategy to develop and grow into a regional player must reflect on the inception and growth of the insurance industry. The main lines of insurance are property and casualty (P&C) for commercial lines to cover large trade or property risks.

When we look at the current status of the takaful industry, we see considerable growth for personal lines for P&C in the GCC and life, household and family (L&H) in Malaysia.

Commercial lines remain a largely untapped consideration because of scale, not appetite. Within the banking industry, large portion of its assets are being underwritten by conventional insurance which has a significant impact on the overall growth momentum for the takaful industry. It creates the classic "chicken and egg" scenario where larger takaful funds are required to underwrite the larger risks. However, to create the larger takaful pools, the industry needs multiple large takaful operators with capacity to underwrite those risks. In the meantime, the large risks continue to seek cover from conventional insurance providers, thereby denying the takaful industry of much needed contributions to help achieve the scale they are striving for.

Our strategic direction for operators is simple:

- Continue to build scale in commercial lines
- Look beyond domestic markets – be selective in the markets where a physical presence is needed, but maintain a presence in others where local operators would not have capacity to underwrite large risks
- Use actuarial analysis to price large risks; getting it wrong could be fatal

These larger regional players can then provide leadership in terms of overall capacity building for the industry and address a number of the business risks that the industry executives cite as challenges to the industry as a whole.

Large regional champions can lead industry

There is a dearth of takaful operators who are capable of providing leadership to the growing internationalization of the industry. There is a need for large, regional champions to lead growth in regional markets and to participate in international markets.

"Commercial lines remain a largely untapped consideration because of scale, not appetite."

- Ashar Nazim

Business challenges

Takaful business risk

Intense competition within specific niche segments and evolving regulations are the top risks identified by the industry.

- Several clients that we have interviewed are considering comprehensive reviews of their strategic and operational plans. Transformational strategies are likely to focus on creating differential propositions by individual markets and risks.

Table 5: Business risk ranking 2013

Business risk	Ranking 2013
Rising competition	1
Evolving regulation	2
Enterprise risk management	3
Global economic weakness	4
Business transformation	5
Rated retakaful shortage	6
Misaligned costs	7
High-risk investment portfolios	8, 9, 10
Inability to achieve underwriting profit	8, 9, 10
Political risks and implications	8, 9, 10
Limited financial flexibility	11
Hostile M&A	12

Business risks 8, 9 and 10 are in the same ranked position.

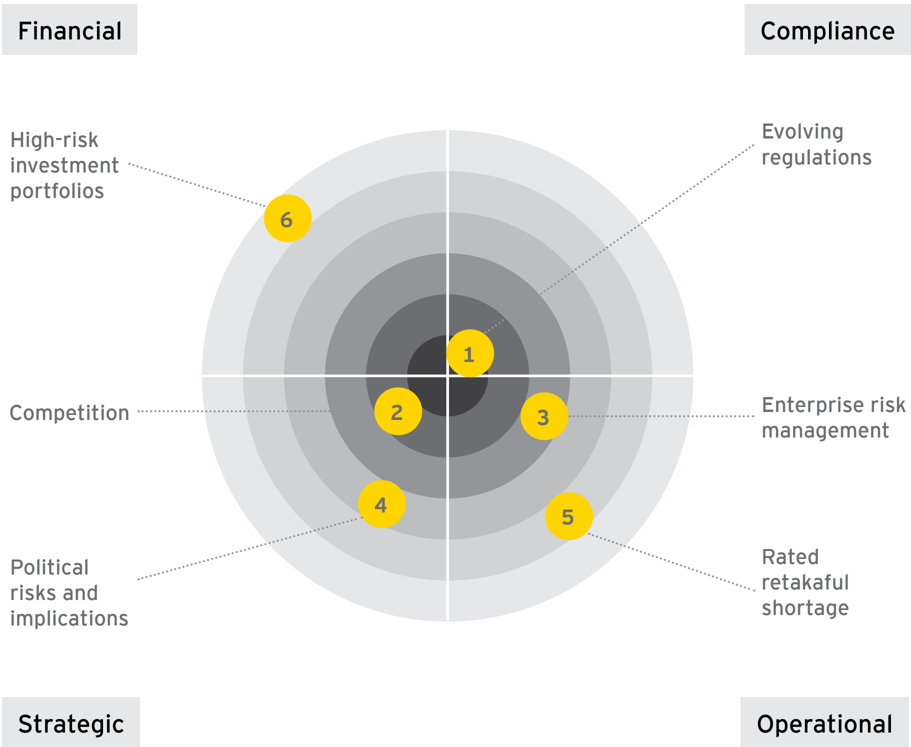
Chart 18: Global takaful business risks

- Respondents were requested to rate 12 business risks.

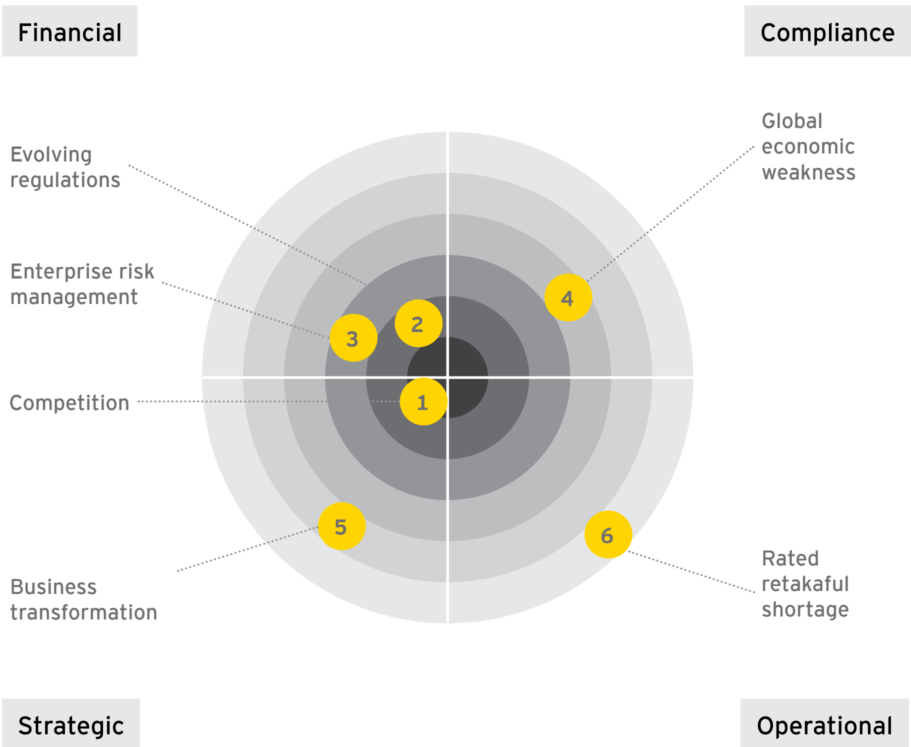
Sources:
Interviews with executives and experts,
EY analysis

Takaful business risks

GCC



ASEAN



Current ambiguities on acceptable takaful models have resulted in the lack of consistency and integration in regulatory frameworks across jurisdictions. The lack of attention to such a fundamental issue threatens the near-term growth prospects of the global industry.

Key concerns raised by survey respondents

Intense industry competition, prevailing risk practices and uncertainty on permissibility of Shariah investment instruments are impacting investor confidence.

Intense competition

- Continued competitive challenges assert premises on industry margins as:
  - Undifferentiated business offerings (competing solely on price)
  - Lack of capacity for underwriting bigger, more complex commercial risks, which are often more profitable
- Encourages the growth of larger, better capitalized operators, which spur the development of:
  - Regional champions
  - Industry consolidation

Evolving regulations

- Regulations differ significantly across jurisdictions and continue to evolve
- Areas of concern:
  - Absence of standard positions on issues such as surplus sharing, the obligations for the provision of Qard to cover deficits in the participants' fund and the rights of participants in takaful companies
  - Lack of uniformity in regulatory frameworks results in reporting challenges for operators who function across jurisdictions
- New regulatory developments that are shaping the industry:
  - Malaysia
    - The Islamic Financial Services Act 2013 will require takaful companies holding composite licenses (both general and family takaful businesses) to separate their businesses.
    - A framework was issued on risk-based capital (RBC) for takaful firms to provide for capital adequacy requirements, which cater for takaful specificities.
  - Qatar
    - Islamic Finance Windows - Islamic Finance Amendments Rules 2012 closed the operation of all Islamic windows by conventional firms with only limited exceptions.

Risk management

- Heightened focus on risk management
- Areas of concern:
  - Reputational risks from varying business models
  - Controls, risk management and reporting framework
  - Conflict between motives of the takaful fund and the shareholder fund
  - Need to maintain positive investment grade ratings
- Operators need to develop a comprehensive enterprise risk management program to allow dynamic focus in addressing risks and to help realize business opportunities

"Risk-based capital for takaful [RBCT[1]] will force some companies to merge or find a new investor to inject more capital to comply with RBCT CAR ratio."

\- Malaysian takaful executive

"There needs to be a better way to implement takaful's conceptual requirements that is commercially viable for shareholders and is considerate of participants' interests."

\- GCC takaful executive

[1]Provide capital adequacy requirements which cater for takaful specificities, with approaches and principles similar to the RBC framework for conventional insurance

Sources:
Interviews with executives and experts, EY analysis

Case study — market study to evaluate a diversification option

Helping our insurance client respond objectively to compulsion

Recent growth in the GCC insurance market has been underpinned by government-driven mandates, particularly for medical insurance. As a result, entirely new markets have emerged in both Saudi Arabia and Abu Dhabi, creating an unprecedented opportunity for insurers and takaful operators alike. However, these opportunities do not come without risks and competition has rapidly intensified in a nascent, untested and evolving marketplace. The challenge for the respective operators is to objectively determine which segments of this new market are most attractive and what capabilities are required to realize their potential.

EY was recently engaged by an incumbent operator to facilitate such a decision-making process. Our client is a leading composite carrier, focused predominantly on life and savings, with an established bancassurance business. The client had conducted its own evaluation of the opportunities in medical insurance, but the client's board had requested an independent review and recommendation. Our market review captured secondary industry data, supplemented by interviews with insurance brokers and existing health insurance carriers, together with the captive commercial banking client base. The aim was to provide a forward-looking view on competitive positioning, profitability and anticipated uptake by customer segment. We combined this insight with projected financial performance to guide discussions around the client's existing capabilities and corresponding gaps required to meet market opportunities.

The selected go-to-market strategy and target operating model would focus on the underpenetrated and relatively lucrative small and medium enterprises (SME) segment, leverage the bancassurance relationship to target a captive customer base, and place a short- to medium-term reliance on a third-party administrator (TPA) and reinsurance to rapidly build required claims and underwriting capabilities. However, this approach would inevitably expose our client to operational risks which could detrimentally impact established lines of business and the bancassurance relationship. These risks, paired with the highly competitive nature of the medical insurance segment, would ultimately result in a recommendation to not pursue growth in medical insurance and instead refocus resources on the underpenetrated life and savings segments. Our recommendation was presented and accepted by the board.

"The challenge for the respective operators is to objectively determine which segments of this new market are most attractive and what capabilities are required to realize their potential."

- Mark Stanley

Regulatory updates

Key issues facing regulators and industry

The essence behind the concept of takaful must be foremost on the minds of both regulators and insurers as they look to evolving regulations and converge towards that of the broader insurance industry.

Source:
EY analysis

Regulator focus

The precise role of regulators can differ between national markets, but their common goals include the protection of consumers and the prevention of systemic disruption. These goals are reflected in the basic obligations with which takaful operators must comply.

The details within these basic obligations vary from country to country, reflecting the different stages of national regulators' journey towards more sophisticated and risk-sensitive supervision. Some GCC countries are at a particularly early stage in developing takaful specific regulation, though 2012 to 2013 has seen progressive initiatives in some countries.

License	Supervise	Inspect
Safeguard consumers' interests	▸ Policyholder protection	▸ Consumer education ▸ Thematic investigation
Orderly growth of the takaful industry	▸ Entry standards ▸ System stability	▸ Licensing of new firms ▸ Macropotential supervision
Promote high standards of behavior, competence	▸ Fit and proper requirements ▸ Conduct requirements	▸ Assess sales, claims processes ▸ Guidance and examples
Take punitive action where needed	▸ Censure ▸ Discipline ▸ Fine	▸ Restrict or revoke licenses ▸ Ban individuals
Ensure financial stability and soundness of firms and industry	▸ Solvency ▸ Risk management ▸ Governance	▸ Monitor capital adequacy ▸ Regulatory reporting ▸ On-site assessment

Source:
EY analysis

Recent developments in takaful regulations

Active regulatory reforms across several markets; however, their prospects for consistency remain slim.

GCC

UAE

Takaful regulation

- A new regulation prohibits conventional insurers from offering takaful products via Islamic "windows." As such, all takaful businesses must be written through stand-alone companies. Significant corporate governance requirements now apply to takaful operators, including specific requirements in relation to ensuring Shariah-compliance of their operations.

Saudi Arabia

Transition to cooperative model

- Saudi Arabia has a single insurance regulatory framework, with no separate provisions for takaful. Since 1 January 2012, the Saudi Arabian Monetary Authority has required all companies to comply with the cooperative model, where policyholders are entitled to 10% of the net surplus. A loss will not be transferred to the policyholders.

UAE

Draft law — mandatory health insurance

- The UAE federal government has prepared a draft law that will make it mandatory for all UAE employers to provide health insurance to employees. A new federal authority will be established to oversee its implementation. While the draft law has not yet been made publicly available, it reportedly imposes fines on employers of up to AED10,000 for each employee on employers without health insurance, and fines of up to AED30,000 who seek to pass on charges to employees for providing them with health insurance.

Qatar

Islamic Finance Windows in the QFC - Islamic Finance Amendments Rules 2012

- The rule amendments closed the operation of all Islamic windows by conventional firms with the exception of takaful insurance businesses conducted under the Insurance Business Rules 2006 (PINS). The impact of this rule change is likely to be minimal given the low level of activity conducted through Islamic windows. The rules commenced on 1 February 2013.

Oman

Law for takaful operators and Shariah-compliant index

- Oman has finalized a draft law to permit the establishment of takaful firms, as distinct from conventional insurers. The new provisions will be issued as part of a general revision of the regulatory framework for insurance, which has been underway for some time. Takaful firms will have to be separate entities, with minimum capital of OMR10 million (US$26m).
- Major local insurers and investors have expressed their intention to invest in takaful providers. The Capital Market Authority has stated that in-principle approval has been given to three applicants.
- In a separate development, which may help ease the difficulty of identifying suitable assets for takaful funds to invest in, the Muscat Securities Market has launched a Shariah-compliant index for investors seeking Islamic equities. It includes 31 publicly listed companies whose financial activities are considered consistent with Shariah.

"A standardized approach to regulations across the GCC could be the game changer for the industry. The ideal approach would be to replicate the 'single passport' system as seen across the EU member states."

\- Noman Mubashir

Regulations for takaful continue to evolve, with some nations forging ahead with sophisticated initiatives, and others at early stages.

ASEAN

Malaysia

Takaful Operating Framework (TOF)

- The TOF requirements came into effect on 1 January 2012 with revisions in June 2013. The objectives are to enhance takaful business efficiency, ensure healthy and sustainable takaful funds and safeguard participants' interests. With this detailed guidance, Malaysia is raising its regulation of takaful to a new level of sophistication.

IFSA 2013

- Effective 30 June 2013, the IFSA regime requires the separation of family takaful and general takaful into separate entities. Existing enterprises have five years to comply.

Takaful RBC

- The RBCT framework started its parallel run in 2013 and will come into full force in 2014. It aims to provide capital adequacy requirements which cater for takaful specificities, with approaches and principles similar to the RBC framework for conventional insurance.

Indonesia

Proposed phasing out of takaful window

- Indonesia currently permits the use of takaful window operations by conventional insurance companies. Window operations are potentially controversial, and, for some time, it has been suggested that they were a temporary measure that would, in time, be required to convert to entities. It is now reported that a new law on insurance will contain the necessary provisions, with a three-year grace period for existing windows to convert. The regulator aims to table the proposed new Act by the end of 2013.

Others

Europe (London)

Islamic insurance platform

- The London-based firm, Cobalt, has developed a Shariah-compliant insurance platform for the London market that uses a syndication model to help spread risk across a panel of underwriters. This is a novel format that could boost capacity in the sector. The company's aim is to cater to large commercial risks and reduce leakage of Islamic assets into the conventional sector.

Pakistan

Takaful Rules 2012 issued by SECP

- Changes in the regulatory framework allow the establishment of a Central Shariah Board at the SECP, permit conventional insurance companies to open takaful windows, establish more formal risk management and rating procedures for takaful operators, and introduce separate solvency requirements for each participant takaful fund. However, the rules on takaful windows have been challenged in court.

Turkey

Liberalization of Islamic banking licenses

- Regulatory reforms to allow new participation banks have positive implications for the entry of foreign Islamic banks and potential future market entry by takaful operators.
- Turkey's Islamic Capital Markets Board is working on new regulations to allow the use of a wider range of Sukuk structures to support the financing of its US$60b planned domestic infrastructure.

"Lack of capacity for the largest commercial risks hinders the expansion of takaful. The biggest risks need large subscription markets. You can't create a takaful subscription market from scratch – but you might manage to spin one off from the London market."

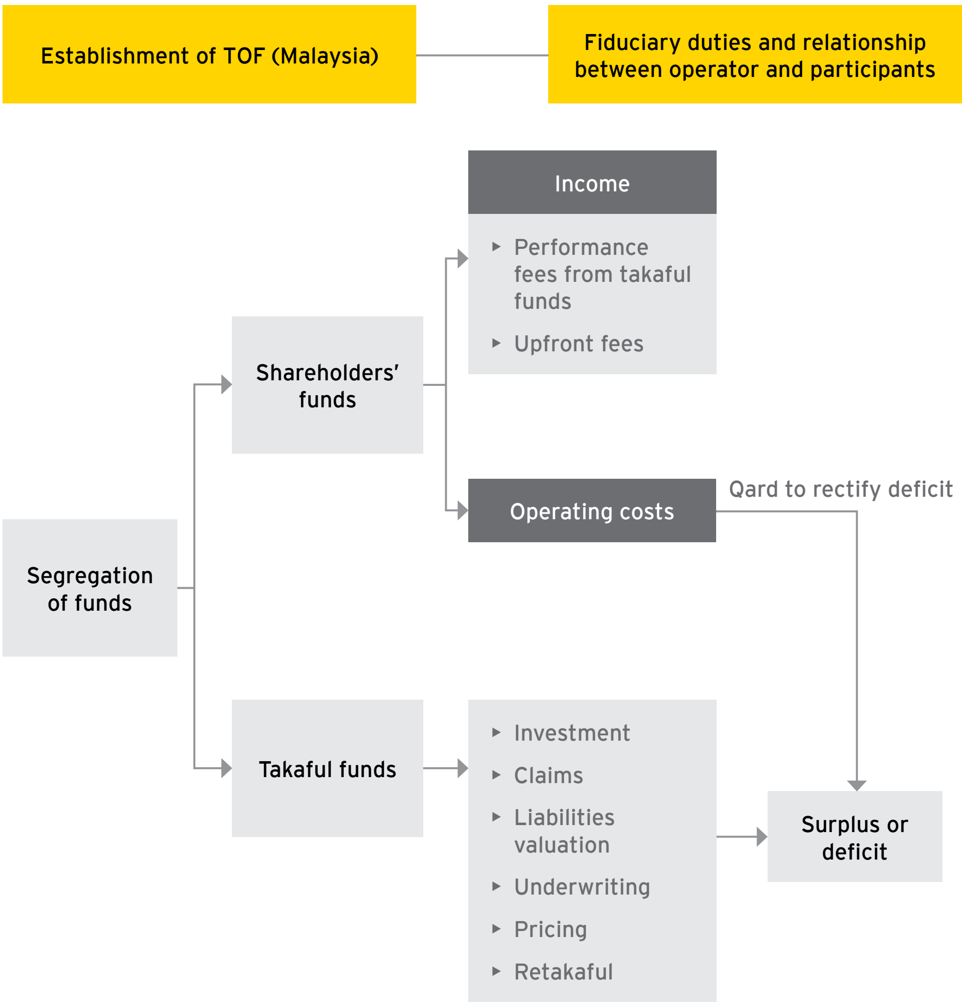
- James Smith

Illustration: Takaful Operational Framework, Malaysia

Malaysia's new TOF enhances the governance of its takaful industry.

Malaysia has a relatively sophisticated regulatory framework for takaful, with detailed requirements in a number of areas. Like many regulators, the Malaysian authorities are placing strong focus on the governance of the business, and its new TOF (effective 2012, and amended in June 2013) reflects this.

Other regulators are also developing similar models, increasing regulatory scrutiny of the way takaful businesses are structured and run.



Four objectives

- To enhance operational efficiency of takaful businesses
- To build healthy takaful funds that are sustainable
- To safeguard the interests of participants
- To promote uniformity in takaful business practices

Five principles

- Uniformity with Shariah principles and consistency with essential takaful features
- Prudent management of takaful funds
- Fairness and transparency in order to protect interests of participants
- Appropriateness of the fees and charges imposed
- Good governance and risk management practices

Four mechanisms

- Effective governance and oversight
- Adequate disclosure and transparency
- Sufficient and competent resources
- Efficient processes and procedures

Source:
Bank Negara Malaysia (BNM),
EY analysis

Capital requirements and integration with AAOIFI and IFSB across markets

Varying capital requirements and AAOIFI standards adoption reflect the wide market differences.

Table 6: Comparison of capital requirements

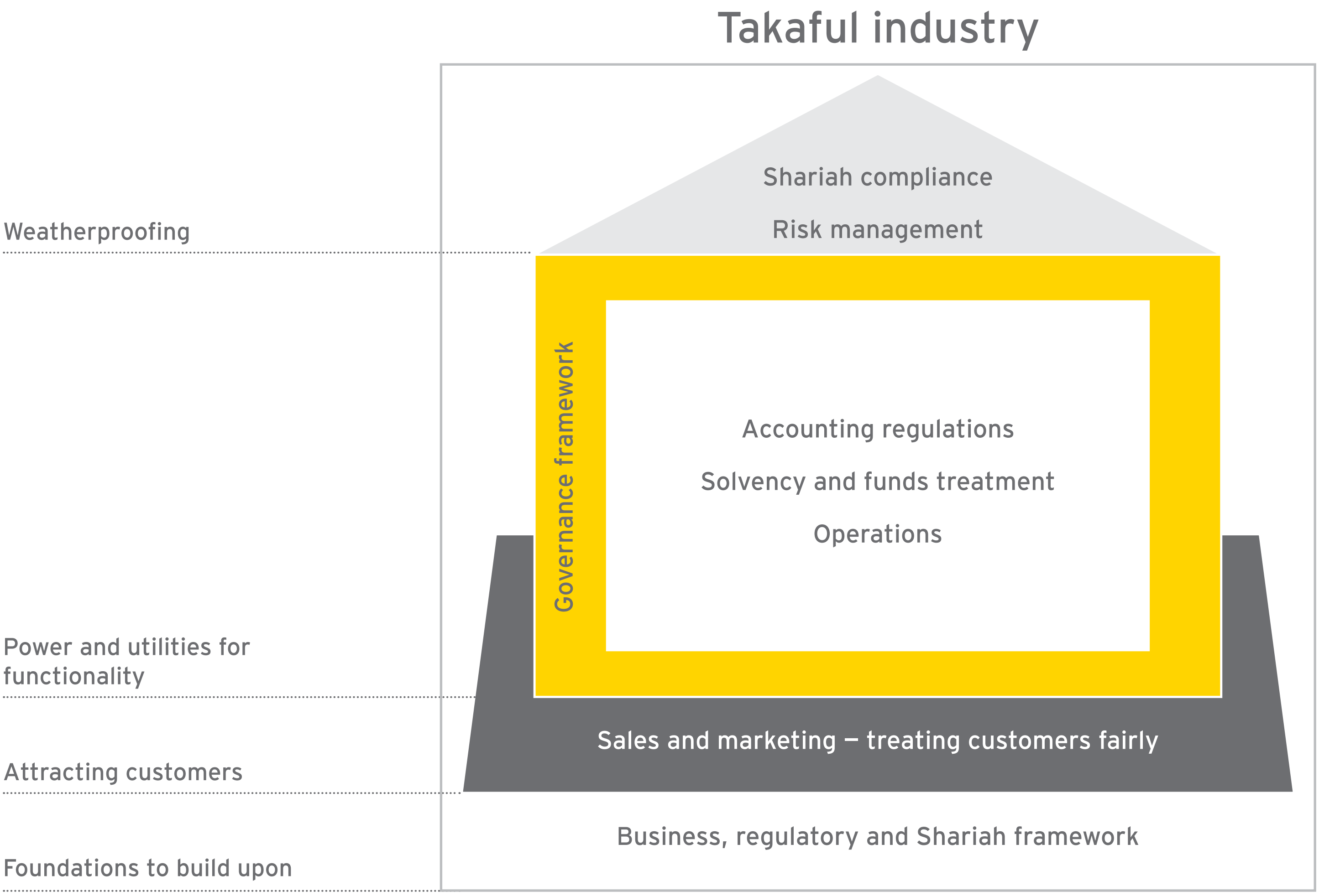
	Features	UAE	Bahrain	Saudi Arabia	Kuwait	Malaysia	Qatar
Minimum regulatory capital requirement (million)	General	AED100 *(US$27.2)*	BD5 *(US$13.3)*	SR100 *(US$26.7)*	KWD10 *(US$35.0)*	MYR100 *(US$30.1)*	US$10
	Life	Same as above	Same as above	Same as above	Same as above	Same as above	Same as above
	Reinsurance	AED250 *(US$68.1)*	BD10 *(US$26.5)*	SR200 *(US$54.3)*	KWD15 *(US$52.5)*	Life: MYR50 *(US$15.1)* Non-life: MYR100 *(US$30.1)*	US$20
AAOIFI standards	Accounting	N	Y	N	N	N	N
	Shariah	N	Y	N	N	N	N
	Governance	N	Y	N	N	N	N
IFSB standards	IFSB standards are often designed as principles and recommendations to guide the development of national standards, rather than to be adopted as a prescriptive code. Malaysia has taken the lead by incorporating various recommendations of the IFSB in its regulations.						

US$: local currencies as at 6 September 2013

Source:
EY analysis

Key strategic issues

Mitigating key regulatory challenges: the way forward



Regulations govern all aspects of the build out for the industry, and this requires an industry-driven agenda with the regulators to clarify and finalize aspects that remain ambiguous and unaddressed.

"Takaful companies have to plan on getting all four stages right for success. Start-ups have a better chance of success, but where change is needed in existing operations, intricate planning is required so the house doesn't fall like a deck of cards."

- Abid Shakeel

Business, regulatory and Shariah framework

- For the purpose of global acceptability, growth and stability, there is an increasing need for standardization of models. This is currently a major barrier to cross-border operations and M&A activities, limiting access to scale.
- Across the world, a number of takaful and insurance models are in place, and several are asserted to be Shariah-compliant solutions. Within those models, there are variation between regions, countries and players within the same market.
- Standard-setting bodies of AAOIFI and IFSB need to produce a convergence roadmap, which should become a reference point for regulators, operators and Shariah scholars alike.

Governance framework

- Governance for Islamic financial institutions has to address additional concerns compared to their conventional counterparts. The most distinctive additional issue relates to Shariah compliance, but the fiduciary responsibilities that arise because of the unique relationship between a takaful operator and the participants are also key.
- Islamic finance and insurance involve a defined set of values and ethics that need to be supported by processes and controls. The associated governance issues pose challenges for regulators because of practical difficulties in regulations and supervisions. It is sometimes difficult to assess whether a role is executive or oversight in nature, whether controls adequately address fiduciary risks, and where lines of responsibility truly lie. This is particularly the case for Shariah-compliance risks where issues and exposures need to be reported not only through line management, but also to the Shariah Board.
- Although fair and transparent treatment of stakeholders is invariably within the regulators' area of responsibility, that is not always the case for Shariah compliance, for which responsibility may lie elsewhere.
- AAOIFI's and IFSB's governance and Shariah governance standards, as well as nationally endorsed codes of conduct and ethics, provide guidance.

Solvency and accounting requirements

- Solvency of the policyholders' funds is a key issue. The IFSB solvency standard and almost all regulatory regimes require the company as a whole to be solvent. This is on the grounds that through a mandatory or constructive obligation of payments of Qard, takaful operators are in practice exposed to a similar risk profile as that of a conventional insurance company.
- The IFSB standard also requires takaful operators to endeavour to ensure that the policyholders' funds also become solvent on their own, without constant Qard support. Setting the right balance is probably among the most important supervisory challenges that regulators are facing. Some use of Qard is essential to cope with the volatility of risk. However, Shariah scholars have expressed concern at the frequent use of Qard as permanent support for the funds.
- In regions where IFRS forms the basis of the regulatory accounting framework, significant technical questions arise when applying the framework, particularly IFRS 4 (Insurance Contracts), to takaful entities. This is expected to be further exacerbated when Phase II of IFRS 4 is introduced, possibly in 2018.
- The list of issues include how to tackle the policyholders' funds, whether or not to apply IFRS 4 to the company as a whole, and how to treat financial instruments and Qard.

Source:
EY analysis

Risk management

- Risk management in takaful is complicated by the existence of segregated funds and the fact that the takaful operator is managing the risks on behalf of the participants. Takaful operators cannot generally look to participants' funds to meet risks that are those of the shareholders alone. However, as a matter of commercial reality, the shareholders' funds are standing behind the participants' risk funds, because of regulatory requirements or commercial necessity for Qard.
- Risk management is closely connected to capital adequacy, as a company's capital needs reflect its risk profile, and can be managed by better risk management. Some risks cannot be mitigated by additional capital. Risk management is therefore a central pillar of Solvency II and of the IAIS Insurance Core Principles and ComFrame, as well as the IFSB solvency standard. The IFSB is also close to issuing a specific standard on risk management. According to the exposed draft of this standard, takaful operators need to have risk management processes and controls in place for both the risks that they are managing on behalf of participants (in their fiduciary capacity) and the risks that they bear on behalf of the shareholders.

Shariah compliance

- Globally, Shariah compliance is a crucial issue for Islamic financial institutions, including Islamic insurance and takaful companies. The role and responsibility of insurance regulators on this issue vary. While some regulators enlist experts and market players to devise and implement standards for ensuring Shariah compliance, others are more prepared to leave it to market forces. Political will and public demand play an important part in the approach taken.
- Regulators are not necessarily formally tasked with supervising Shariah compliance in takaful companies. However, from the point of view of stakeholders, Shariah noncompliance is a serious matter and potentially damaging to the sector as well as individual institutions. Regulators may reasonably be expected to require a company to have a proper governance framework for Shariah compliance, even if the regulator does not have explicit responsibility for supervising that compliance. IFSB standards shed light on the supervisory role in Shariah compliance. National practices are likely to continue to vary, as conditions differ from country to country, so achieving a standard practice on this matter will not be easy.

Customers

- Increasing competition for takaful companies mean they have to apply greater sophistication in how they develop and implement their brand strategy. Seamless transition through the multiple stages, from brand exposure right through to purchasing across a multi-channel distribution model, is what operators must strive to offer.
- Another key component of any policy renewal decision is the level of service a customer receives at the time of a claim or at the renewal process itself. Many operators are looking at outsourcing selected customer processing activities to specialist service providers to improve on the customer experience. Although not the initial reason to outsource, those that have outsourced have also benefited from improved fraud detection and this has had a positive impact on the combined operating ratio.

Source:
EY analysis

Country in focus

Growth of Islamic finance and takaful

With low insurance penetration rates across key Muslim developing markets, there is huge growth potential for takaful products.

The growth of takaful markets reflects the broader performance and prospects of the Islamic banking and finance sector in these countries.

Over the recent decade, the double-digit growth of Islamic banking assets was accompanied by similar growth of gross takaful contributions across many key Muslim developing markets, including Saudi Arabia, UAE and Malaysia.

Despite takaful's strong growth, the insurance penetration rates in these key markets are generally low (on average just 2%), indicating that strong growth is still possible.

In the longer term, by sheer Muslim demographics and economic scale, emerging markets such as Turkey and Indonesia offer wider upside potential.

Chart 19: Market potential — selected markets (including rapid growth markets)

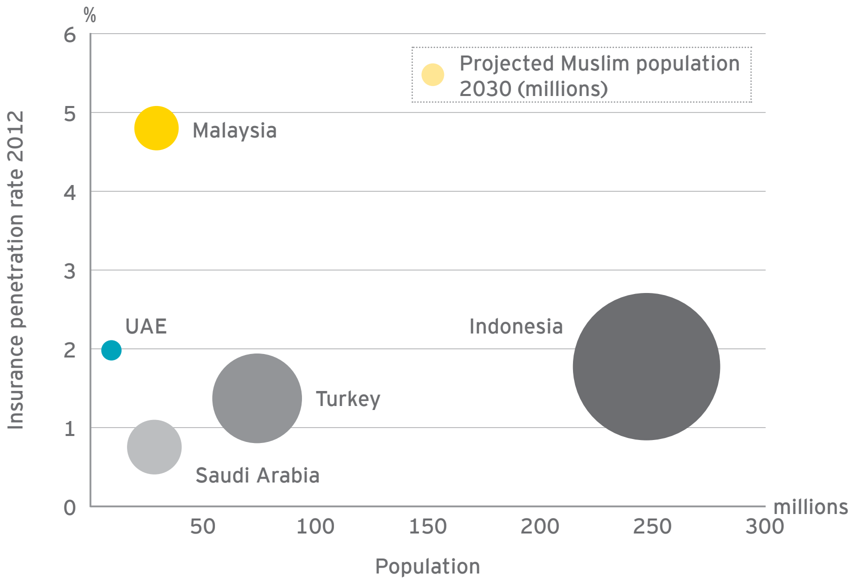
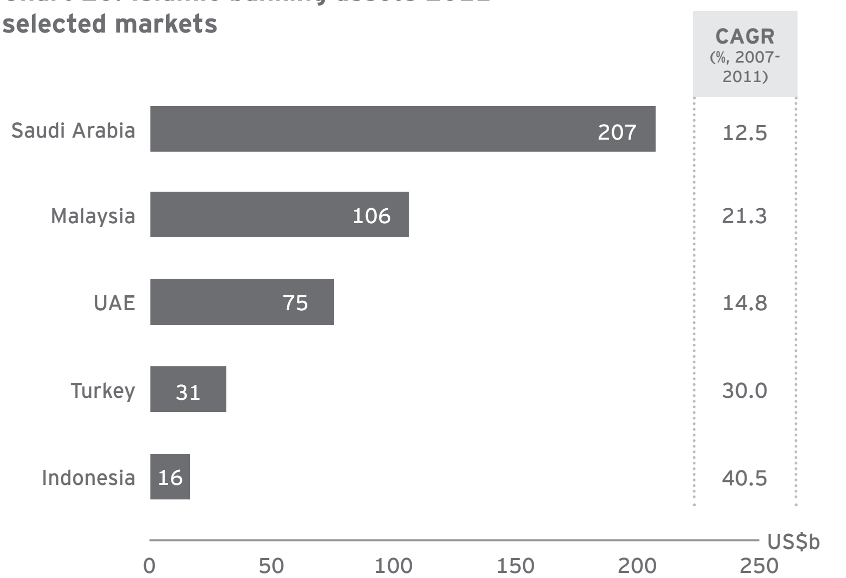


Chart 20: Islamic banking assets 2011 — selected markets



Sources:
World Bank's databank;
The World Islamic Banking Competitiveness Report 2012-2013, EY;
The Future of Global Muslim Population 2011, Pew Research;
World Insurance Report 2012, Swiss Re;
EY analysis

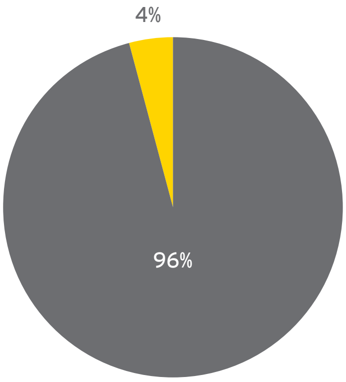
Insurance: profile of selected markets

GCC countries are characterized by a large general insurance segment, in contrast to ASEAN countries that are largely into life- and family-centric markets.

Chart 21: Total insurance composition in selected markets, 2012

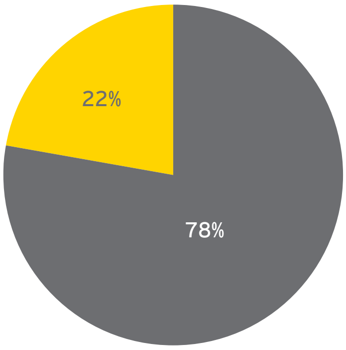
General | Life and family

Saudi Arabia



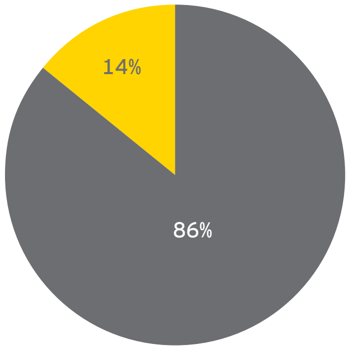
Total premiums US$5.6b | CAGR 14% (2010-2012e)

UAE



Total premiums US$6.8b | CAGR 7% (2010-2012e)

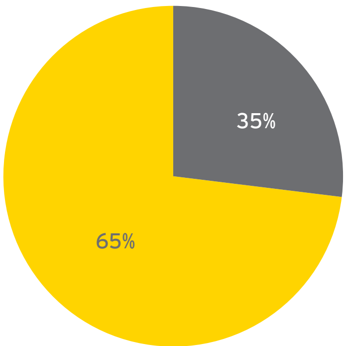
Turkey



Total premiums US$10.6b | CAGR 6% (2010-2012e)

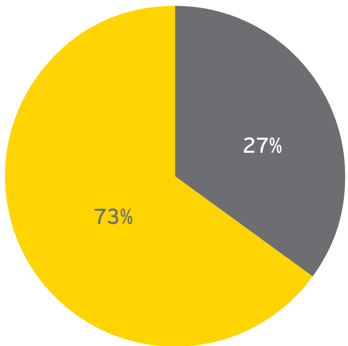
Over the medium to longer term, there appears to be ample opportunities for the growth of family takaful products in GCC countries — and vice versa, the growth potential for general takaful products in ASEAN countries.

Malaysia



Total premiums US$14.7b | CAGR 11% (2010-2012e)

Indonesia



Total premiums US$16.9b | CAGR 20% (2010-2012e)

Sources:
World Insurance Report 2012, Swiss Re;
Indonesia Insurance Report Q3 2013, BMI;
Malaysia Insurance Report Q3 2013, BMI;
Saudi Arabia Insurance Report Q3 2013, BMI;
Turkey Insurance Report 2013, BMI;
UAE Insurance Report Q2 2013, BMI;
EY analysis

Global competitiveness index

A market's maturity and competitiveness level will set the growth pace for its takaful industry.

The wide regional differences and varying stages of maturity of the six selected markets are well reflected by the results of the global competitiveness index chart.

Among key takaful markets, UAE achieved the best score for basic requirements. On innovation and sophistication factors, Malaysia scored well, as did UAE.

Moving forward, emerging markets for takaful growth include Turkey, Indonesia and in the distant future, Kazakhstan.

Chart 22: Global competitiveness index

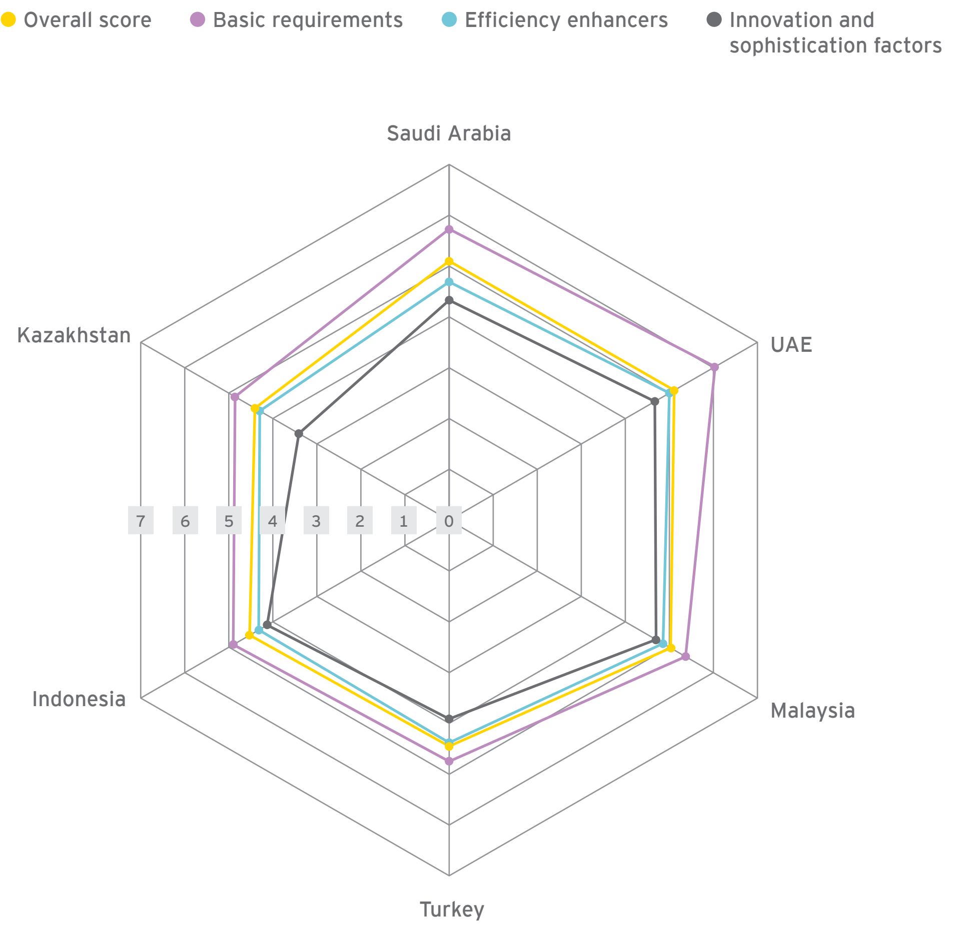


Table 7: Global competitiveness index score breakdown

Country	Rank	Overall score	Basic requirements	Efficiency enhancers	Innovation and sophistication factors
UAE	19	5.11	6.04	5.00	4.67
Saudi Arabia	20	5.10	5.73	4.69	4.33
Malaysia	24	5.03	5.37	4.86	4.70
Indonesia	38	4.53	4.90	4.32	4.13
Turkey	44	4.45	4.75	4.38	3.91
Kazakhstan	50	4.41	4.86	4.30	3.41

Source:
The Global Competitiveness Report 2013-2014, World Economic Forum

Growth potential in rapid growth markets

Following the expansion of the Brazil, Russia, India, China and South Africa (BRICS) countries, a new set of rapid growth markets is emerging, and these should be carefully analyzed to target potential opportunities for takaful companies.

The analysis of a number of financial and nonfinancial dimensions should be part of the overall consideration investors look for in deciding where to get the best investment returns.

However, any investment decision must be made on a commercial basis and not for altruistic reasons. One of the biggest problems consistently identified over the last three years by investors is their lack of return on investments.

Anyone considering establishing a new takaful company must do so expecting little or no return for three to five years. In addition, the characteristics of the takaful business model and its nascent nature of returns is not industry comparable to those of conventional insurers.

Our initial analysis shows three markets in ASEAN and a further four markets in Europe, Middle East, India and Africa (EMEIA) that may be of interest to potential investors, as well as operators with expansion plans.

Growth potential in rapid growth markets

Regulatory enhancements are presenting new opportunities in rapid growth markets such as Turkey and Indonesia. The challenge is to build on the lessons learned from core Islamic finance markets to expeditiously address rising demand.

"Any investment decision must be made on a commercial basis and not for altruistic reasons."

\- Brandon Bruce Sta Maria

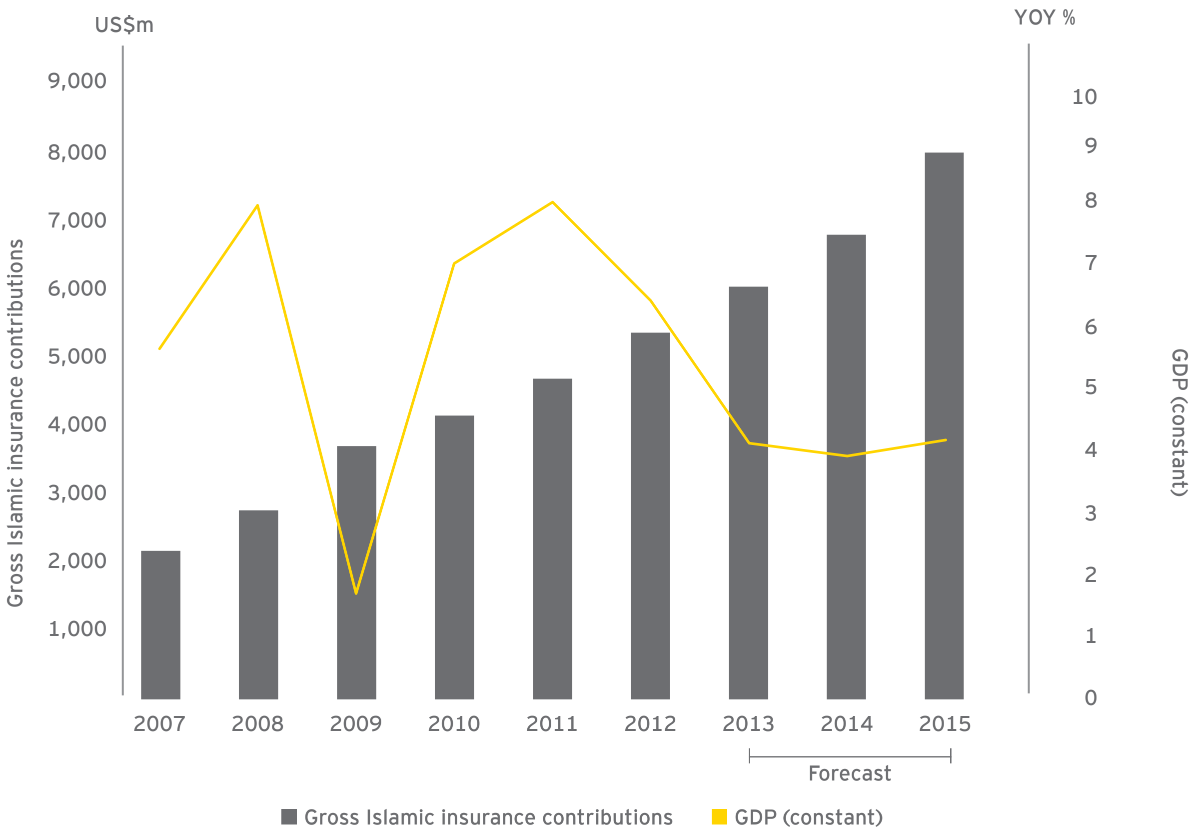
Saudi Arabia

Modest growth for Saudi Arabia's Islamic insurance industry

Given that Saudi Arabia's population is under-insured by international standards (only 0.75% penetration rate), with a population of 28 million and a moderate annual GDP growth rate of 4% between 2013 and 2015, there appears to be potential for modest growth. The growth of family takaful, however, may be limited by Saudi Arabia's social welfare system, which for the most part is considered generous.

Chart 23: Saudi Arabia's gross Islamic insurance contributions and GDP growth

CAGR (%)	2007-12	2013f-15f
Gross Islamic insurance contributions	20	13
GDP (constant)	7	4



Sources:
World Bank's databank;
World Economic Outlook Database April 2013, IMF;
World Islamic Insurance Directory 2013, Middle East Insurance Review;
World Insurance Report 2012, Swiss Re;
Saudi Arabia Insurance Report Q3 2013, BMI;
EY analysis

Total insurance[1]	
Total premiums (US$b, 2012):	5.6
YOY growth (%, 2012):	14
CAGR (%, 2010–12):	14
Insurance penetration (%, 2012):	0.75

No. of industry players[2]	
Cooperative:	34

Key players[3]

- Al Rajhi Company for Cooperative Insurance
- Al Ahli Takaful Company
- BUPA Arabia for Cooperative Insurance Company
- The Company for Cooperative Insurance
- SABB Takaful Company

Key indicators	
GDP (US$b, 2012):	727.3
Population (millions, 2012):	28.3
Muslim share of total population (%, 2010e):	97.1
Projected Muslim population (millions, 2030):	35.5
Global competitiveness index:	5.10

Table 8: Saudi Arabia's SWOT analysis — insurance sector, 2013

Strengths	Weaknesses
▸ Largest domestic market for nonconventional insurance products ▸ Favorable economic conditions ▸ Increasing awareness of life and family product ranges.	▸ Firms lack scale for the mega infrastructure in the country ▸ High competition for market share creating artificially low prices ▸ Growth mainly due to compulsory health insurance; life segment is small since Saudi Arabian households generally have little need for life insurance
Opportunities	**Threats**
▸ Increasing demand for health insurance ▸ Expatriates represent a reliable source of business for life MNC ▸ Global financial volatility has had little adverse impact on Saudi Arabia's insurers ▸ Large infrastructure projects provide an immediate pipeline of opportunity for big ticket risks	▸ Lack of scale and access to capital ▸ Weak profitability ▸ Lack of skilled and knowledgeable client-facing sales-force ▸ Intense price competition is forcing operators to under price risk and expose them to high claims.

[1]Saudi Arabia has a cooperative insurance.

[2]Inclusive of cooperative reinsurers. Number of players may not be comprehensive.

[3]Key players are not in any particular order.

Sources:
World Bank's databank;
The Saudi Insurance Market Report 2012, SAMA;
The Future of Global Muslim Population 2011, Pew Research;
World Islamic Insurance Directory 2013, Middle East Insurance Review;
World Insurance Report 2012, Swiss Re;
Saudi Arabia Insurance Report Q3 2013, BMI;
World Economic Outlook database, April 2013, IMF;
EY analysis

Case study: Malaysia

Malaysia continues to take the lead in the ASEAN takaful industry and holds over 70% share of gross takaful contributions.

Malaysia's takaful industry is characterized by its family's takaful segment, which commands over three-quarters of domestic market share. Today, takaful operators are diversifying into the general takaful segments.

Malaysia has 12 takaful operators and four retakaful operators.

With a relatively diversified and stable economy and a young population who are largely Muslim, there is significant upside potential for Malaysia to continue its leadership and innovation as a regional center of excellence for the global takaful industry.

A key driving factor of Malaysia's steady growth in takaful is the country's regulatory headway in ensuring a supportive and facilitating environment to nurture the growth of its nascent industry.

Among recent regulatory enhancements to improve takaful's business efficiency and ensure healthy and sustainable funds in safeguarding participants' interests include the TOF, the RBCT and the IFSA 2013.

Also of note is the positive impact of takaful on the capital markets industry. The upside of having developed the family takaful industry is the need it created for suitable longer term investments. It is no surprise that Malaysia is also one of the top destinations for Sukuk issuance with an increasing number of global institutions choosing to tap into the strong demand for long-term investments here.

Malaysia, world's number one on family takaful

Malaysia has emerged as the world's largest family takaful market. With a proven model and regulatory clarity, the country is set to further build on this leadership position.

"Malaysia can continue its leadership and innovation as a regional center of excellence for the global takaful industry."

\- Dato' Rauf Rashid

Malaysia

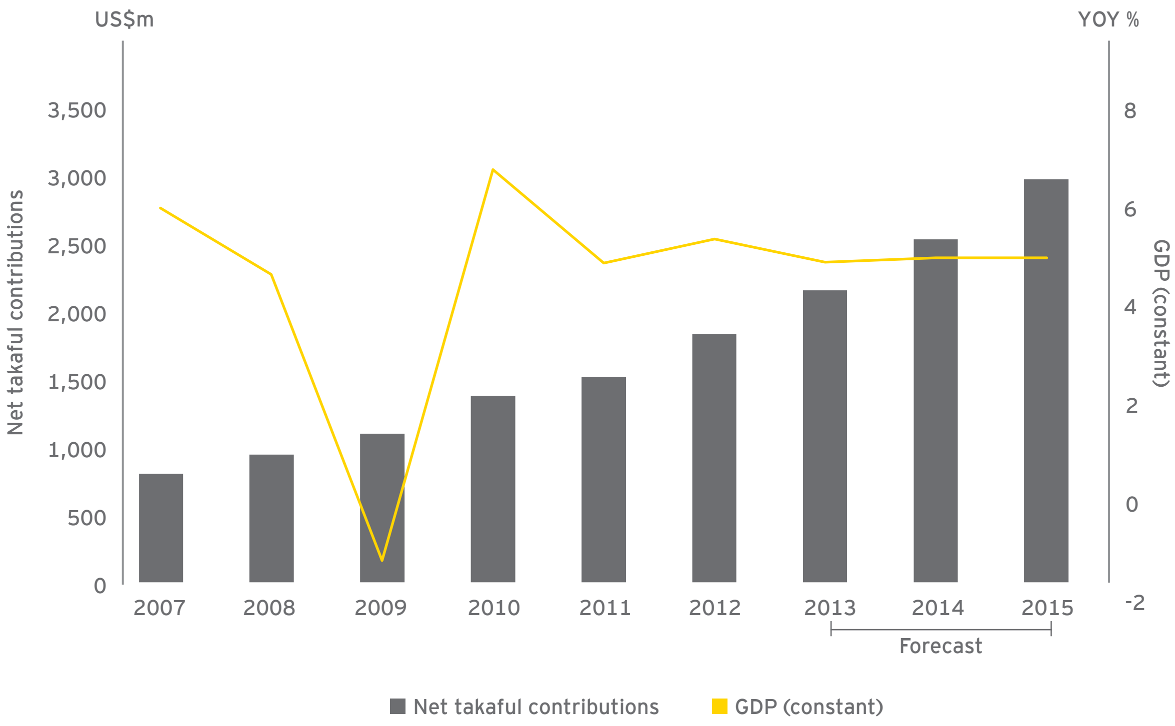
Malaysia's relatively young and under-insured population and continued regulatory enhancements will spur its takaful industry forward.

Malaysia is the second largest takaful market in the world. Its takaful industry grew by 21% in 2012, which is more than double the growth of the broader insurance industry at 9%.

Given that Malaysia has a largely under-insured population with a low insurance penetration rate (still only 4.8%) and that the Islamic finance sector is supported by government efforts in strengthening the industry's regulatory framework, prospects for takaful are encouraging.

Chart 24: Malaysia's net takaful contributions and GDP growth

CAGR (%)	2007-12	2013f-15f
Net takaful contributions	18	18
GDP (constant)	4	5



Sources:
World Bank's databank;
World Economic Outlook Database, April 2013, IMF;
Annual Takaful Statistics 2012, BNM;
World Islamic Insurance Directory 2013, Middle East Insurance Review;
World Insurance Report 2012, Swiss Re;
Malaysia Insurance Report Q3 2013, BMI;
EY analysis

Total insurance	
Total premiums (US$b, 2012e):	14.7
YOY growth (%, 2012e):	9
CAGR (%, 2010–12e):	11
Insurance penetration (%, 2012):	4.8

Takaful	
Net contributions (US$m, 2012):	1,931
YOY growth (%, 2012):	21
CAGR (%, 2010–12):	15

No. of industry players[1]	
Conventional:	42
Takaful:	16

Key takaful players[3]

- Etiqa Takaful (subsidiary of Maybank)
- Prudential BSN Takaful
- Sun Life Malaysia Takaful[2]
- Syarikat Takaful Malaysia
- Takaful Ikhlas (subsidiary of MNRB Holdings)

Key indicators	
GDP (US$b, 2012):	303.5
Population (millions, 2012):	29.2
Muslim share of total population (%, 2010e):	61.4
Projected Muslim population (millions, 2030):	22.8
Global competitiveness index:	5.03

Table 9: Malaysia's SWOT analysis — insurance and takaful sector, 2013

Strengths	Weaknesses
▸ The takaful industry has experienced strong growth (CAGR 15%) ▸ General takaful is below 10% of total non-life premiums ▸ Family takaful represents 16% of total life premiums ▸ Favorable regulations to promote the growth of Islamic finance ▸ Foreign multinationals can have partial ownership of life and general insurance ▸ General and family takaful are growing more rapidly than conventional insurance	▸ General insurance penetration has been trending downward in the last five years ▸ Local general companies lack scale – many Malaysian corporate groups have considered selling their interests to foreign multinationals
Opportunities	**Threats**
▸ Rise in demand for "risk" and unit-linked investments ▸ Scope for consolidation in general insurance ▸ New IFSA 2013 to spur industry restructuring and improve operator focus on takaful businesses	▸ Slowdown in GDP growth is constraining growth of the general insurance segment ▸ Bancassurance has had mixed performance ▸ Large players have lost ground with banks' lack of interest in promoting life products

[1]Inclusive of conventional reinsurers and retakaful operators. Number of players may not be comprehensive.

[2]Formerly known as CIMB Aviva Takaful

[3]Key players are not in any particular order.

Sources:
World Bank's databank;
BNM website - list of licensed insurance companies and takaful operators in Malaysia;
The Future Of Global Muslim Population 2011, Pew Research;
World Islamic Insurance Directory 2013, Middle East Insurance Review;
World Insurance Report 2012, Swiss Re;
Malaysia Insurance Report Q3 2013, BMI;
World Economic Outlook database, April 2013, IMF;
EY analysis

UAE

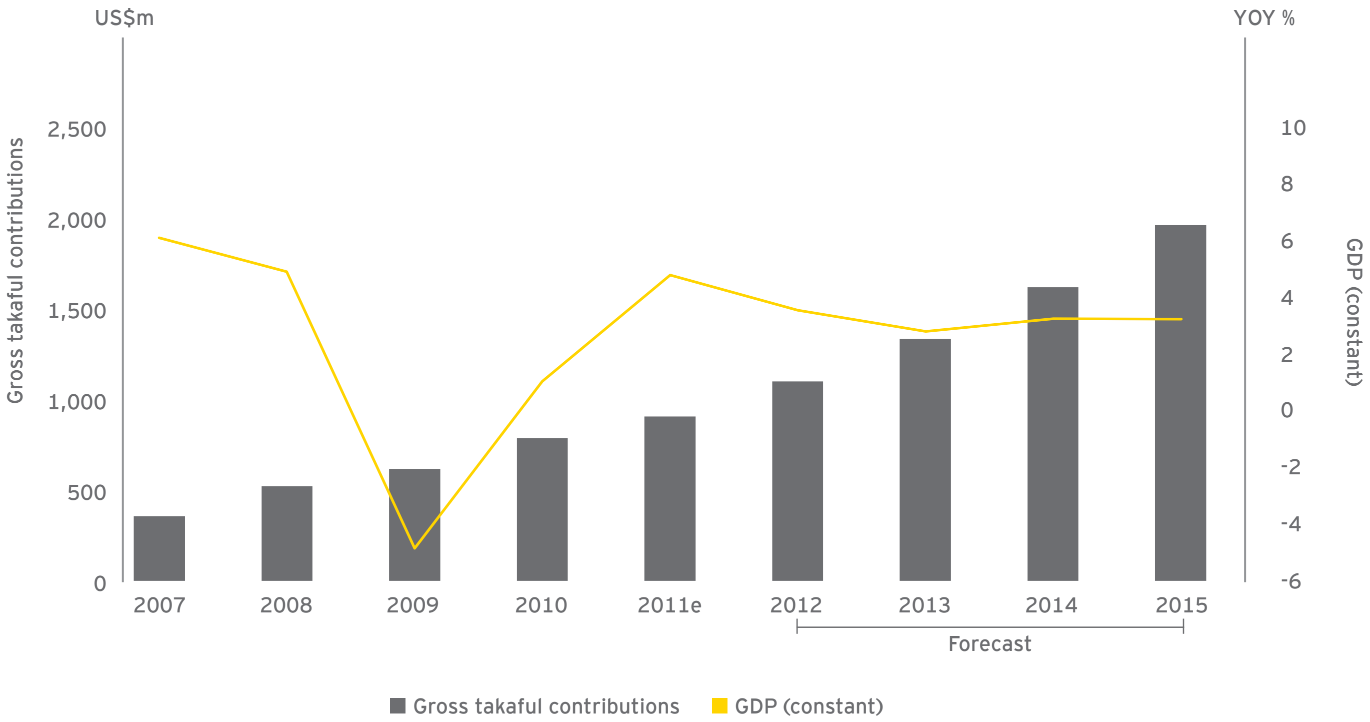
Despite a slow economy, UAE's takaful industry remains buoyant. The health insurance segment offers the potential for strong growth.

Given its low insurance penetration rate, the UAE takaful industry is expected to maintain its double-digit growth trajectory.

Similar to other GCC countries, the UAE insurance market is dominated by general business lines. Competition among general insurers is intense, and market players do not expect general insurance penetration to increase substantially. There is better upside potential in the health insurance segment with the pending introduction of mandatory health insurance for employees.

Chart 25: UAE's gross takaful contributions and GDP growth

CAGR (%)	2007-12f	2013f-15f
Gross takaful contributions	25	21
GDP (constant)	2	4



Sources:
World Bank's databank;
World Islamic Insurance Directory 2013, Middle East Insurance Review;
World Insurance Report 2012, Swiss Re;
UAE Insurance Report Q2 2013, BMI;
EY analysis

Total insurance	
Total premiums (US$b, 2012e):	6.8
YOY growth (%, 2012e):	5
CAGR (%, 2010-12e):	7
Insurance penetration (%, 2012):	1.98

Takaful	
Gross contributions (US$m, 2012f):	1142
YOY growth (%, 2012f):	21
CAGR (%, 2010-12f):	18

No. of industry players[1]	
Conventional:	52
Takaful:	10

Key takaful players[2]

- Abu Dhabi National Takaful Company
- Islamic Arab Insurance Co. (Salama)
- Methaq Takaful Insurance
- National Takaful Company (Watania)
- Takaful Emarat

Key indicators	
GDP (US$b, 2012):	358.9
Population (millions, 2012):	9.2
Muslim share of total population (%, 2010e):	76.0
Projected Muslim population (millions, 2030):	5.0
Global competitiveness index:	5.11

Table 10: UAE's SWOT analysis — insurance and takaful sector, 2013

Strengths	Weaknesses
▸ Large market with buoyant growth (CAGR of 7%) - open to foreign competition (DIFC attracted international insurers and reinsurers who can reinsure local businesses) ▸ Increased transparency in stock exchange listings ▸ Strong regulatory clarity across UAE: Abu Dhabi Financial Centre, Dubai International Financial Centre and Dubai Financial Services Authority, with onshore and offshore capability for takaful and retakaful operators	▸ Industry fragmentation - 62 small scale insurers ▸ Regulatory environment needs improvement ▸ Rising claims in certain lines of business
Opportunities	**Threats**
▸ Bancassurance and direct sales-force provide the best route to market with expatriate customer base already familiar with the model. ▸ Recently launched a masterplan on Islamic economy offers a comprehensive "growth platform" for Islamic products and services, including takaful ▸ Digital infrastructure in place with alternative sales channels increasingly important	▸ Intense competition in many general insurance lines ▸ General insurance penetration unlikely to increase substantially ▸ Low interest rates — local insurers are cash-rich ▸ Competition from other regional centers for international businesses

[1]Inclusive of conventional reinsurers and retakaful operators. Number of players may not be comprehensive.

[2]Key players are not in any particular order.

Sources:
World Bank's databank;
Emirates Insurance Association website (List of members);
The Future Of Global Muslim Population 2011, Pew Research;
World Islamic Insurance Directory 2013, Middle East Insurance Review;
World Insurance Report 2012, Swiss Re;
UAE Insurance Report Q2 2013, BMI;
World Economic Outlook database, April 2013, IMF;
EY analysis

Indonesia

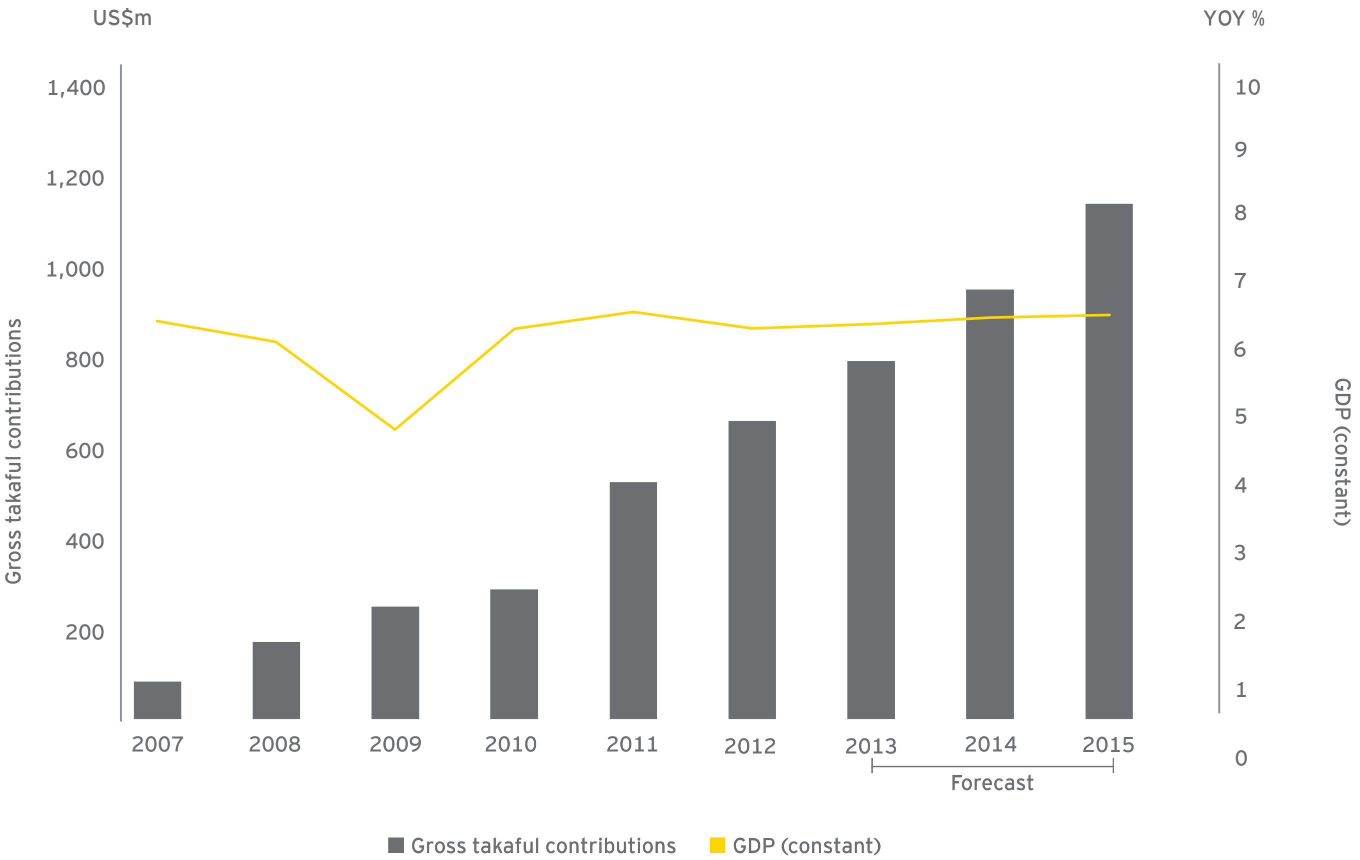
Indonesia's large Muslim population and strong takaful growth bode well for the industry's medium- to long-term growth.

Takaful has been growing strongly, though from a low base, and there is clearly a demand and need for takaful, especially in the family takaful segment. In 2012, Indonesia's takaful industry grew 26% and this compares with the moderate 13% growth of the broader insurance industry.

Indonesia has 46 takaful operators, including windows in conventional insurers. By the end of 2013, there will be a drafted law that will phase out existing takaful windows over three years. With a significant US$16b (2011) Islamic banking asset industry catering strong Muslim market base and a large young and under-insured Muslim-dominant (88%) 247 million populace, Indonesia has considerable potential for takaful growth. Islamic financial assets is predicted to reach nearly US$1.6 trillion by 2023.

Chart 26: Indonesia's gross takaful contributions and GDP growth

CAGR (%)	2007-12	2013f-15f
Gross takaful contributions	51	20
GDP (constant)	6	6



Sources:
World Bank's databank;
World Islamic Insurance Directory 2013, Middle East Insurance Review;
World Insurance Report 2012, Swiss Re;
Indonesia Insurance Report Q3 2013, BMI;
EY analysis

Total insurance	
Total premiums (US$b, 2012e):	16.9
YOY growth (%, 2012e):	13
CAGR (%, 2010–12e):	20
Insurance penetration (%, 2012):	1.77

Takaful	
Gross contributions (US$m, 2012):	666
YOY growth (%, 2012):	26
CAGR (%, 2010–12):	52

No. of industry players[1]	
Conventional:	139
Takaful:	46

Key takaful players[3]

- PT Asuransi Takaful Keluarga
- PT Asuransi Takaful Umum
- PT Jaya Proteksi Takaful
- PT Prudential Life Assurance[2]
- PT AXA Mandiri Financial Services[2]

Key indicators	
GDP (US$b, 2012):	878.2
Population (millions, 2012):	246.9
Muslim share of total population (%, 2010e) :	88.1
Projected Muslim population (millions, 2030):	238.8
Global competitiveness index:	4.53

Table 11: Indonesia's SWOT analysis — insurance and takaful sector, 2013

Strengths	Weaknesses
▸ Boom in life insurance, double digit rise in premiums ▸ Indonesia: one of the few life markets that is large and rapidly growing — CAGR of 20% ▸ Rapid growth in takaful — CAGR of 52% over 2010-2012	▸ Under-developed life insurance held back by past problems ▸ Firms lack scale (especially non-life segment) and pricing power market
Opportunities	**Threats**
▸ 80% of Indonesians are uninsured ▸ Rapid bancassurance growth — there is a clear demand for takaful (especially family/life, risk investment and unit-linked products) ▸ At 80%, Indonesia's upper limit for foreign ownership of insurers is higher than other countries in the region	▸ Business environment is still a work in progress ▸ To maintain speed of expansion, insurers would need a massive injection of new capital in the next two years

[1]Inclusive of conventional reinsurers, retakaful operators and takaful window operators. Number of players may not be comprehensive.

[2]Conventional insurers with an Islamic insurance unit.

[3]Key players are not in any particular order.

Sources:
World Bank's databank;
Quaterly Report Q1 2013, Indonesian Financial Services Authorities (OJK);
The Future Of Global Muslim Population 2011, Pew Research;
World Islamic Insurance Directory 2013, Middle East Insurance Review;
World Insurance Report 2012, Swiss Re;
Indonesia Insurance Report Q3 2013, BMI;
World Economic Outlook database, April 2013, IMF;
EY analysis

Turkey

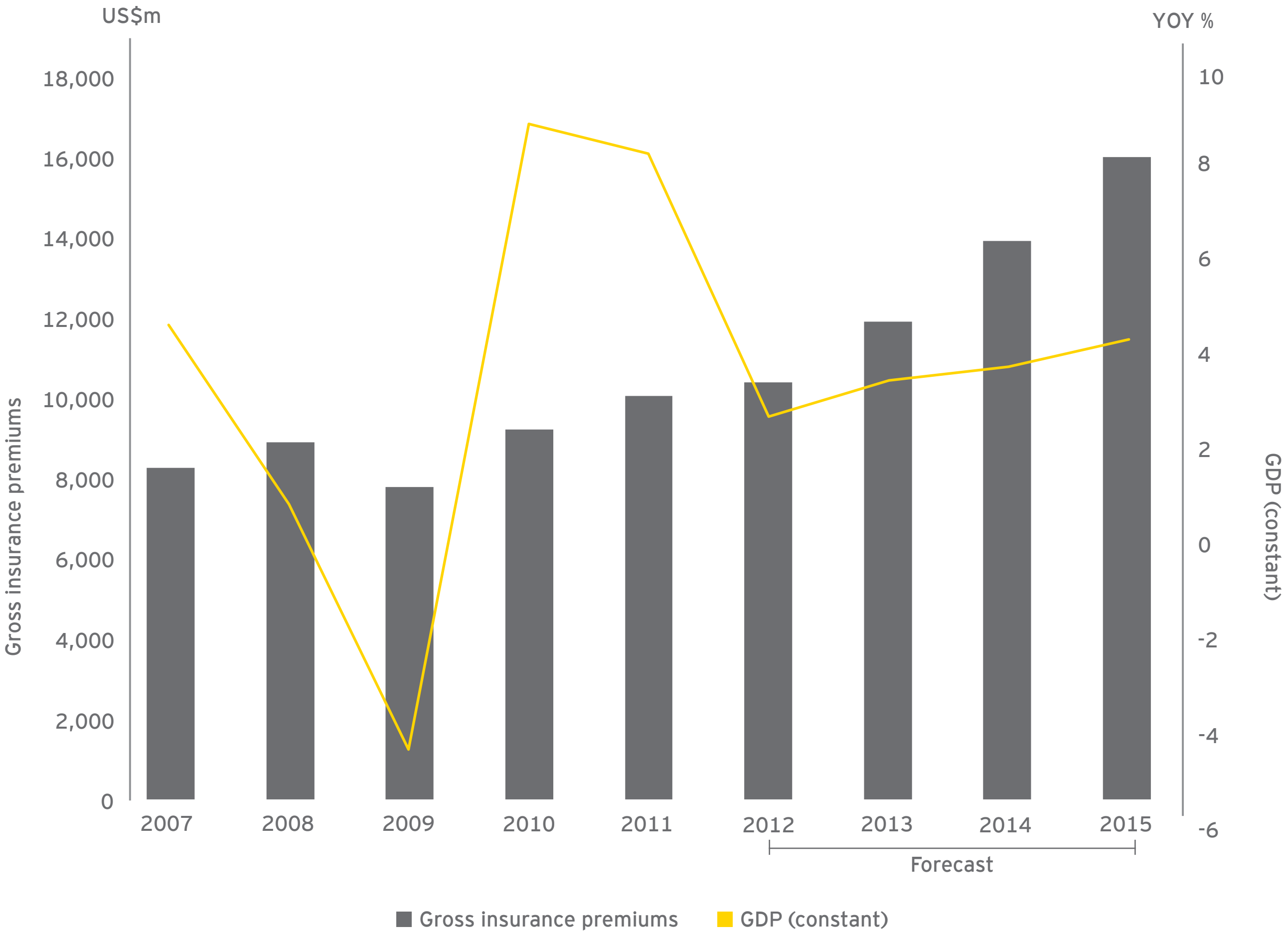
Turkey's large middle-income Muslim population and positive economic growth conditions offer regulatory changes that will open potential takaful growth opportunities.

Turkey's insurance industry grew by 3% in 2012. However, its insurance penetration rate is low at approximately 1.4%.

With a US$31b (2011) Islamic banking asset industry which provides a strong Muslim market base and a population of 74 million that is 99% Muslim, Turkey has considerable potential for takaful growth. While some companies have been established with the intention to write insurance on a takaful basis, the current regulatory framework limits the scope for full takaful operation. In the longer term, with the Islamic banking industry's market share set to increase to 15% market share by 2023, we can anticipate takaful's market to rise in tandem if regulatory conditions are conducive.

Chart 27: Turkey's gross insurance premiums and GDP growth

CAGR (%)	2007-12f	2013f-15f
Gross insurance premiums	5	16
GDP (constant)	3	4



Sources:
World Bank's databank;
World Islamic Insurance Directory 2013, Middle East Insurance Review;
World Insurance Report 2012, Swiss Re;
Turkey Insurance Report 2013, BMI;
EY analysis

Total insurance[1]	
Total premiums (US$b, 2012f)[2]:	10.6
YOY growth (%, 2012f)[2]:	3
CAGR (%, 2010–12f)[2]:	6
Insurance penetration (%, 2012):	1.37

No. of industry players[3]	
Conventional:	63
Takaful:	-

Key players[4]

- Anadolu Sigorta
- AXA Sigorta
- AKSigorta

Key indicators	
GDP (US$b, 2012):	794.5
Population (millions, 2012):	74
Muslim share of total population (%, 2010e) :	98.6
Projected Muslim population (millions, 2030):	89.1
Global competitiveness index:	4.45

Table 12: Turkey's SWOT analysis — insurance sector, 2013

Strengths	Weaknesses
▸ Large general insurance segment, with strong growth annually (CAGR of 6%) ▸ Rapid growth in life segment ▸ Life and general insurance open to foreign MNCs — banks and commercial groups are open to inward investments by bancassurance and other distribution deals with foreign majors	▸ Fragmented market — lack pricing power ▸ Unfavorably low prices have been set by treasury ▸ Rife competition among insurers at the low end of the market
Opportunities	**Threats**
▸ Large market — no constraints on development; insurance sector is underdeveloped (especially life) ▸ Pension reform has potential to provide a boost to the growth of the life segment	▸ Nature of bond market — difficult for life insurance companies to find long-term assets that match their liabilities ▸ Non-life pricing problem — decline in profitability ▸ Deteriorating inflation — leads to rise of combined ratios of non-life companies

[1] Takaful is not permitted by regulation in Turkey.

[2] BMI forecast

[3] Number of players may not be comprehensive.

[4] Key players are not in any particular order.

- There are a few players (e.g., Neova Sigorta, Isik Sigorta) that have product(s) that are modeled to ensure transactions are in accordance with takaful.

Sources:
World Bank's databank;
The Future Of Global Muslim Population 2011 (Pew Research);
World Islamic Insurance Directory 2013 (Middle East Insurance Review);
World Insurance Report 2012 (Swiss Re);
Turkey Insurance Report 2013 (BMI);
World Economic Outlook database, April 2013, IMF;
EY analysis

Exploring latent market demand

Given the varying stages of economic maturities, demographic profiles and market sophistication of the near developed and emerging countries, including rapid growth markets, the potential exists to tap latent underlying demand for takaful and ethical insurance products.

Although takaful's near- to mid-term future growth is likely to originate in large Muslim-dominated markets, from Indonesia to Turkey and selected CIS countries, operators should not lose sight of EMEIA markets and begin to explore the gaps that exist today. Adopting a multi-market approach will not only help manage risk diversification, but will also offer profitable opportunities in niche segments.

However, the real prize is likely to be in those countries where insurance penetration is high and conventional insurance is the dominant provider. Not surprisingly, these markets are in the West and Far East where takaful is not in great demand by the populous. Nevertheless, takaful is about providing protection for the collective, not about providing protection for Muslims only. General insurance is a commodity product. Some providers lead by price. Others by features and benefits — or by service. For a takaful operator to lead in an already competitive marketplace, its strategy needs to be clear and differentiated and most importantly, well executed.

Of emerging interest is the question of brand identity. If a takaful company does not name itself a takaful company, does not promote itself as such or inform the masses that it is, is it then a takaful company?

The Muslim markets have great potential with low insurance penetration and a combination of increasing demand, population and wealth. However, our perspective is that other markets should not be ignored. Takaful serves the same purpose as insurance but with the additional dimension of being Shariah-compliant. Rapid growth markets around the world could be potential markets where critical mass can be achieved very quickly, but this requires detailed market analysis and planning.

Varying markets, varying potentials

Growth and profitability prospects for takaful operators vary significantly by markets and sectors, depending on the market's economic maturity, industry and regulatory structure.

"Adopting a multi-market approach will not just help manage risks diversification, but also offers global scale and prospects to capture profitable opportunities in niche segments."

\- Abid Shakeel

In summary

Report recaps

1. Growth and profitability prospects for takaful operators vary significantly by markets and sectors, depending on the market's economic maturity, industry and regulatory structure.

2. Despite volatility in financial markets, there appears to be growth momentum in three key markets: Saudi Arabia, UAE and Malaysia.

   Acquisition of market share, however, has not necessarily translated to profitability in many instances.

3. Regulatory enhancements have opened new opportunities in rapid growth markets such as Turkey and Indonesia.

   The challenge is to build on the lessons learned from core Islamic finance markets to expeditiously address latent demand.

4. Malaysia has emerged as the world's largest family takaful market. With a proven model and regulatory clarity, the country is set to further build on this leadership position.

5. There is a dearth of takaful operators who are able to provide leadership to the growing internationalization of the industry. There is a need for regional champions as a starting point.

Appendices

Glossary

Term	Definition
Bancassurance	An arrangement in which a bank and an insurance company form a partnership so that the insurance company can sell its products to the bank's client base, using the bank’s distribution channels.
Contributions	Monetary contributions provided once or periodically by a participant to a takaful pool. Part of these contributions will be treated as Tabarru (donations with the objective of common good) and the remaining portion will be used for investment.
Gharar	Extreme uncertainty
Haram	Unlawful, forbidden as per the tenets of Islam
Maysir	Gambling or speculation
Mudaraba	An agreement between the entrepreneur and the capital provider in a business venture to share profits of the joint venture based on an agreed profit sharing ratio. Losses are borne by the capital provider only.
Qard	Loan
Retakaful	A contract whereby one party, for a consideration, agrees to indemnify another party, wholly or partially, against loss or liability the latter has covered under a separate and distinct takaful contract.
Riba	The concept of Riba is basically the loan taken with the condition that the borrower will return more than the amount borrowed. The interest charged by a financial institution is Riba.
Shariah	Islamic canon law is derived from three sources: the Quran, the Hadith or Sunnah and Ijtihad (Ijma and Qiyas). Ijma means consensus of scholars and Qiyas means analogical reasoning based on Quran or Hadith precedents. A “Shariah-compliant” product meets the requirements of Islamic law. A “Shariah board” is the committee of Islamic scholars available to an Islamic financial institution for guidance and supervision in the development of Shariah-compliant products and in the process of offering these products to the financial institution’s customers. A “Shariah adviser” is an independent Islamic scholar that advises Islamic institutions on the compliance of the institution’s products and services and its operations with Islamic law.
Takaful	Mutual protection or guarantee provided by a group of people against a defined risk or catastrophe befalling one’s life, property or any form of valuable assets. Operationally, takaful refers to participants mutually contributing to a common pool of funds with the purpose of having mutual indemnity in the case of a peril or loss to any of the participants.
Wakala	Agency

Fundamentals of takaful

Takaful is the Shariah-compliant alternative to conventional insurance.

Conventional insurance (non-mutual)	The company accepts premiums from the insured at a level that it anticipates will cover claims and result in a profit. This process of anticipation is akin to Maysir (speculation).
	The insured pays premiums to the company in exchange for indemnity against risks that may not occur. This process of ambiguity is akin to Gharar (uncertainty).
	The company engages in investments that may derive income from interest and prohibited industries. This process is akin to Riba (usury) and relates to Haram (prohibited) activities.

Takaful	Takaful is based on the concept of social solidarity, cooperation and mutual indemnification. It is a pact among a group that agrees to donate contributions to a fund that is used to jointly indemnify covered losses incurred by the members. While the concept of takaful revolves around mutuality and is founded on a noncommercial basis, the operations and the fund are commonly managed by a takaful operator on a commercial basis.

Five key elements	Mutual guarantee — the basic objective of takaful is to pay a defined loss from a defined fund. The loss is covered by a fund created by the donations of policyholders. Liability is spread among the policyholders and all losses divided between them. In effect, the policyholders are both the insurer and the insured.
	Ownership of the fund — donating their contributions to the takaful fund, policyholders are owners of the fund and are entitled to its profits (this varies slightly between the adopted models, which are described later).
	Elimination of uncertainty — donations, causing transfer of ownership to the fund, are voluntary to mutually help in the case of a policyholder's loss without any pre-determined monetary benefit.
	Management of the takaful fund — management is by the operator who, depending on the adopted model, utilizes either (or a combination) of two Shariah-compliant contracts, namely Mudaraba or Wakala.
	Investment conditions — all investments must be Shariah-compliant, which prohibits investment in Haram industries and requires the use of instruments that are free of Riba.

Source:
EY analysis

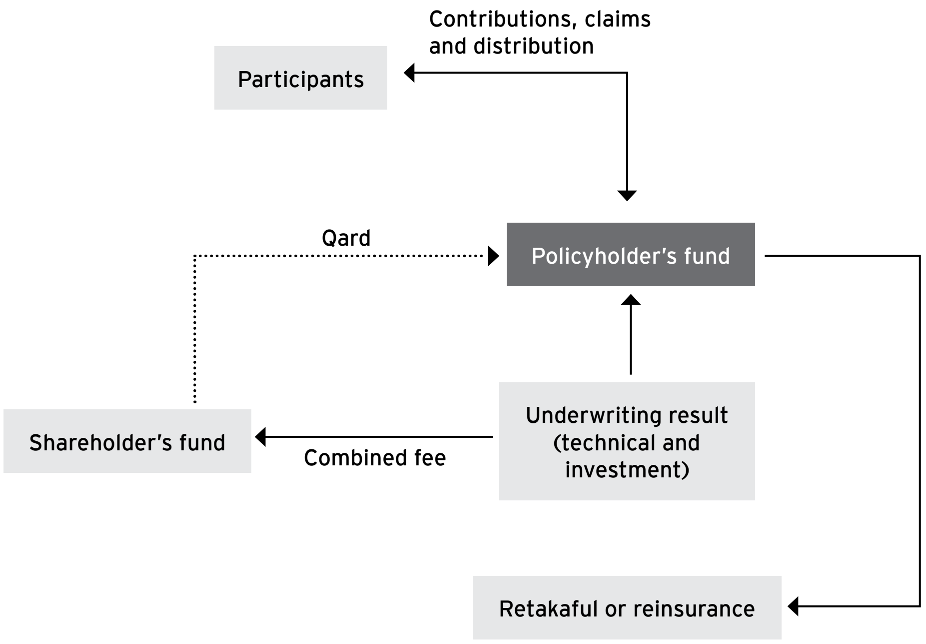
Model comparisons

Takaful uses a system based on the principle of mutual assistance to share risk, collectively, among a group of members.

	Takaful	Cooperative insurance	Mutual insurance	Proprietary or commercial insurance
Contracts utilized	▸ Donation and mutual undertaking based on non-remunerative or non-commutative contract ▸ Not an exchange /commutative contract	▸ Mutual contract	▸ Mutual contract – considered to be an exchange contract on principles of mutuality	▸ Remunerative or commutative exchange contract
Company's responsibility	▸ Manage the participants' fund ▸ Pay claims from underwriting fund ▸ Provide interest-free loan to underwriting fund in case of deficit	▸ Pay claims with underwriting fund ▸ Pay for deficits, if any	▸ Pay claims with underwriting fund	▸ Pay claims
Participants' responsibility	▸ Pay contributions	▸ Pay contributions (and pay for deficits in some models)	▸ Pay premiums (and pay for deficits in some models)	▸ Pay premiums
Capital utilized for underwriting business	▸ Participants' funds and in case of shortfall, temporary access to shareholders' equity on a Qard basis	▸ Participating capital and accumulated surplus	▸ Participating capital, accumulated surplus and guarantee capital (if applicable)	▸ Shareholders' equity
Investment considerations	▸ Shariah-compliance and prudential	▸ No restrictions except prudential	▸ No restrictions except prudential	▸ No restrictions except prudential

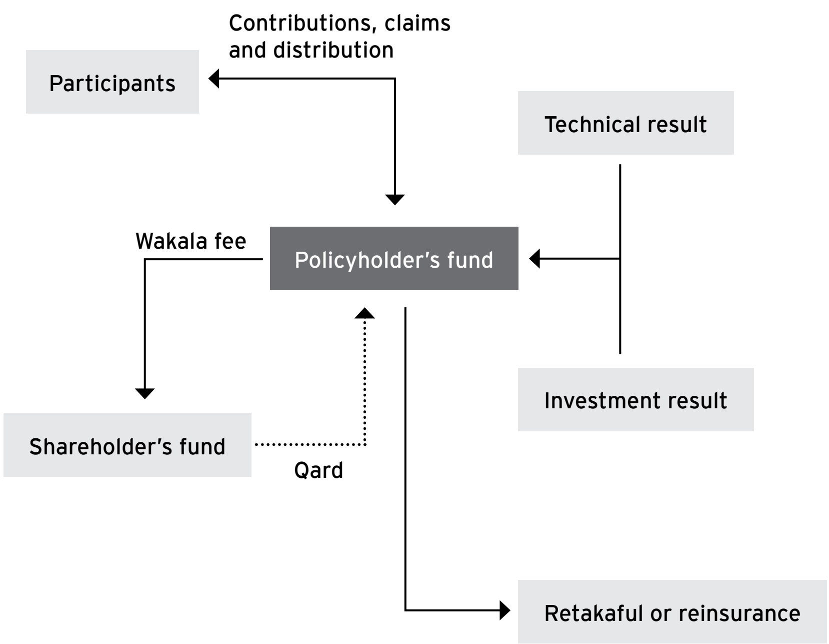
Source:
EY analysis

Mudaraba model



A principal-manager agreement is used between the policyholders (Rab al Mal — capital providers) and the takaful operator (Mudarib — entrepreneur) for both underwriting and investment activities.

Wakala model

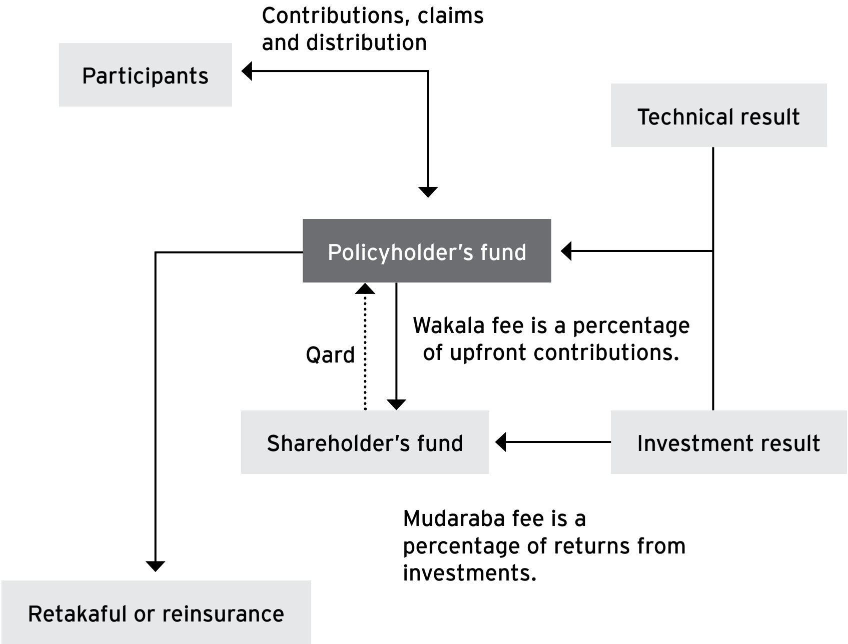


A principal–agent arrangement (Wakala) is used between the policyholders and the takaful operator for both underwriting and investment activities.

- Participants are policyholders.
- Shareholders' fund is takaful operator.
- Combined fee is a percentage share of the underwriting result — a combination of the technical result and investment returns.
- The Qard is an interest-free loan provided by the shareholders to the policyholders' fund in the event of deficit.

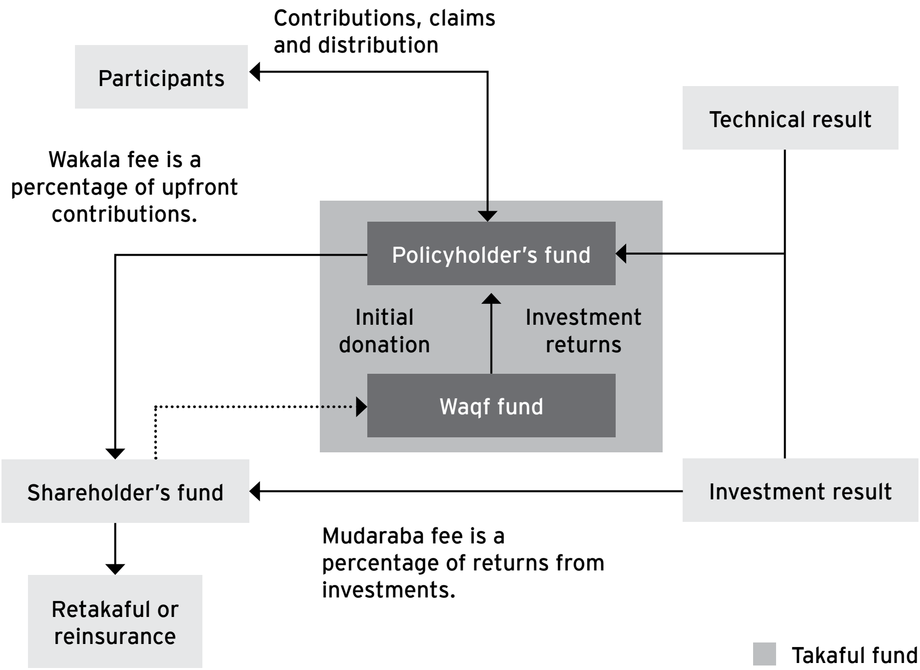
Source: EY analysis

Hybrid model



A combination of the principal-agent (Wakala) and principal-manager (Mudaraba) arrangement: Wakala is used for underwriting activities and Mudaraba is used for investment activities.

Waqf model

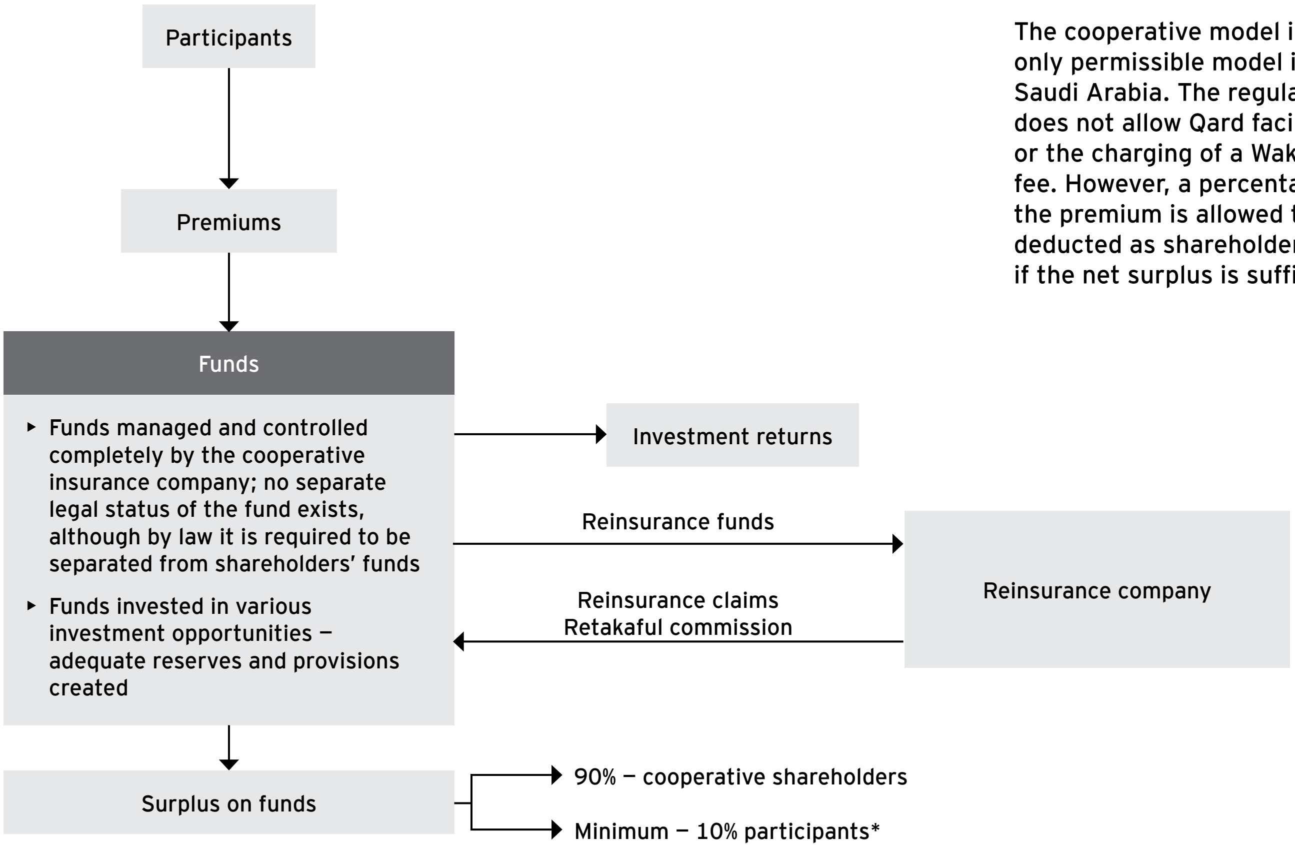


A Waqf fund is established via a donation by shareholders. This Waqf cannot be used to settle claims. The combined model is used to manage participants' contributions with a Qard facility provided by shareholders.

- Participants are policyholders.
- Shareholders' fund is a takaful operator.
- The Qard is an interest-free loan provided by the shareholders to the policyholders' fund in the event of deficit.
- The Wakala Waqf model has proven popular in Pakistan and relies upon an initial donation from the shareholders to establish a Waqf fund for the participants. Only the investment returns from this fund (and not the Waqf amount itself) may be used to pay claims. Contributions are managed through the combined model with shortfalls in the participations' fund being met through a Qard facility from shareholders, Pakistani Shariah scholars do not allow surplus distribution amongst participants.

Source: EY analysis

Cooperative model



The cooperative model is the only permissible model in Saudi Arabia. The regulator does not allow Qard facility or the charging of a Wakala fee. However, a percentage of the premium is allowed to be deducted as shareholder income if the net surplus is sufficient.

- Participants are policyholders.
- Shareholders' fund is a takaful operator.
- *At management's discretion

Source: EY analysis

Research methodology

For the purpose of this report, desktop research and a survey have been employed.

Desktop research

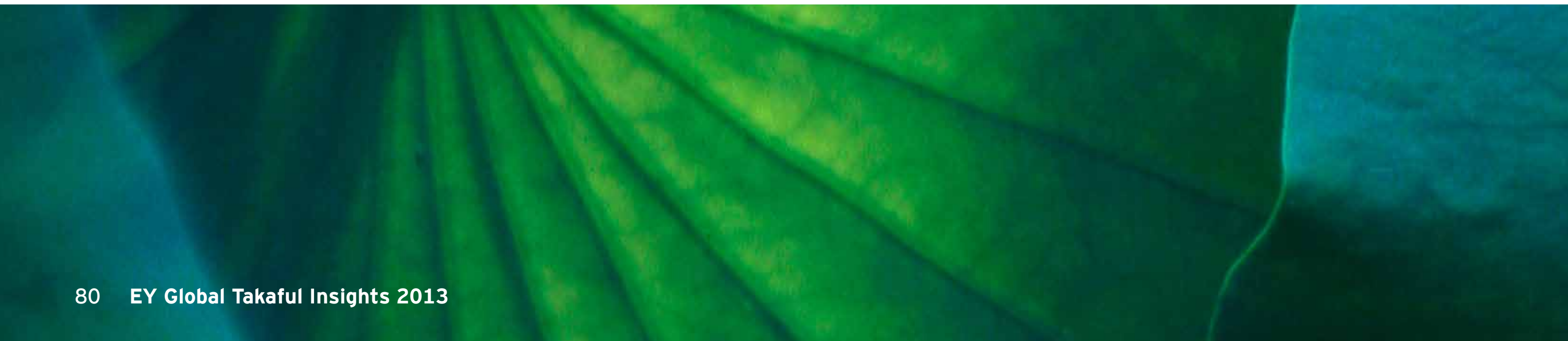
Desktop research consists of two sections:

1. Industry performance: assess the size of the global and selected takaful markets and market developments, including M&As, product trends, regulatory updates and country SWOTS.
2. Financial performance: collate selected financial data to estimate financial ratios in specific markets.

- In the industry performance section, various secondary sources have been used, including news articles, third-party industry reports and regulatory authorities' reports.
- In the financial performance part, six countries are studied. They are Saudi Arabia, UAE, Bahrain, Kuwait, Qatar and Malaysia.
- The time period of analysis is from financial years 2010 to 2012. Selected financial data was collated by reviewing companies' financial statements.
- In total, desktop collation included 116 insurers – 69 conventional insurers, 27 cooperative insurers and 20 takaful operators across the six countries.
- In making comparisons, the countries were categorized as follows:
    - GCC – Bahrain, Kuwait, Qatar and UAE (excluding Saudi Arabia)
    - Saudi Arabia
    - Malaysia
- As the financial performance ratios calculated were based on a sample of players, the average ratios are indicators only.
- Saudi Arabia's insurance companies operate under a cooperative business model, which is different from the takaful practice in other countries. Islamic insurance is included in the analysis but shown separately where necessary.

Financial performance sample breakdown

No. of sampled companies	2010	2011	2012
GCC – insurance	32	34	31
GCC – takaful	14	13	10
Saudi Arabia – cooperative insurance	20	27	21
Malaysia – insurance	33	31	16
Malaysia – takaful	5	6	6



Survey methodology

- The survey seeks to identify key trends and business risks for the global takaful industry. These were used to gauge business sentiments and identify key areas for inquiry. The questions centered on three areas:
  - Business confidence, demand and supply
  - Mega trends
  - Business risks
- The surveys were either completed through in-depth interviews with executives, experts and industry observers, or independently by the respondents themselves.
- A total of 23 responses were received (interviews and self-completed surveys, excluding informal discussions).
- Survey period was from May to July 2013.

Business risk ratings

- The survey provided a list of business risks and requested respondents to rate each of them on a "5-level" Likert scale to reflect its severity to their respective business over the coming 12 months. Respondents were also asked to add any additional risks that they felt were important.
- The results of this rating process were tabulated and a relative ranking was assigned to each risk. This formed the basis of our comparative study with the 2012 results.

Business risks radar

- The EY risk radar is an effective framework that allows us to present the top six business risks in the takaful industry.
- The risks at the center of the radar are those that the respondents thought would pose the greatest challenge to the industry in 2013.

Business risk categories

- The radar is divided into four sections that correspond to the EY Risk Universe™ model.
  - **Compliance** threats originate in politics, law, regulation or corporate governance.
  - **Financial** threats stem from volatility in markets and the real economy.
  - **Strategic** threats are related to customers, competitors and investors.
  - **Operational** threats impact the processes, systems, people and overall value chain of a business.

Anonymity and quotes

- All respondents were assured of anonymity.
- Quotations have been used to support arguments made in the report.

Abbreviations

Abbreviation	Full term
AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institution
ASEAN	Association of Southeast Asian Nations
BNM	Bank Negara Malaysia
BRICS	Brazil, Russia, India, China, South Africa
CAGR	Compound annual growth rate
CAR	Capital adequacy ratio
CIS	Commonwealth of Independent States
CMA	Capital Market Authority
COR	Combined operating ratio
EMEIA	Europe, Middle East, India, Africa
GCC	Gulf Cooperation Council
GDP	Gross domestic product
GWC	Gross written contributions
IAIS	International Association of Insurance Supervisors
IDB	Islamic Development Bank
IFRS	International Financial Reporting Standard
IFSA	Islamic Financial Services Act

Abbreviation	Full term
IFSB	Islamic Financial Services Board
IMF	International Monetary Fund
L&H	Life and health
M&A	Mergers and acquisitions
MENA	Middle East and North Africa
P&C	Property and casualty
QFC	Qatar Financial Centre
RBCT	Risk-based capital for takaful
ROE	Return on equity
SAMA	Saudi Arabian Monetary Authority
SECP	Securities and Exchange Commission Pakistan
SME	Small and medium enterprises
TOF	Takaful Operating Framework
TPA	Third-party administrator
UAE	United Arab Emirates
UK	United Kingdom
USA	United States of America
WIID	World Islamic Insurance Directory

Table summary

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Background	1	Some of the recent M&As in Asia
	2	Some of the recent M&As in MENA
Financial performance	3	Snapshot of financial performance, 2012
	4	Investment composition
Business challenges	5	Business risk ranking 2013
Regulatory updates	6	Comparison of capital requirements
Country in focus	7	Global competitiveness index score breakdown
	8	Saudi Arabia's SWOT analysis — insurance sector, 2013
	9	Malaysia's SWOT analysis — insurance and takaful sector, 2013
	10	UAE's SWOT analysis — insurance and takaful sector, 2013
	11	Indonesia's SWOT analysis — insurance and takaful sector, 2013
	12	Turkey's SWOT analysis — insurance sector, 2013

Chart summary

Section	Chart no.	
Industry performance and outlook	1	Global gross takaful contributions by region, 2007–12f
	2	Share of global gross takaful contributions by region, 2012f
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	7	Key takaful market centers
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Financial Performance	11	Average return on equity
	12	Average combined operating ratio
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	21	Total insurance composition in selected markets, 2012
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	26	Indonesia's gross takaful contributions and GDP growth
	27	Turkey's gross insurance premiums and GDP growth

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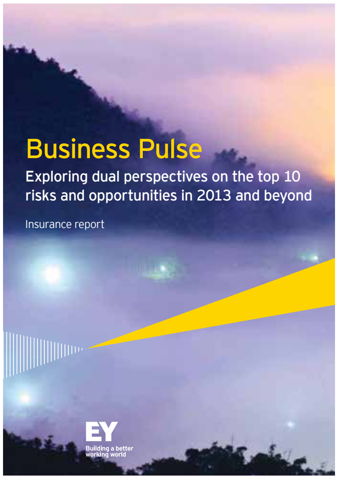
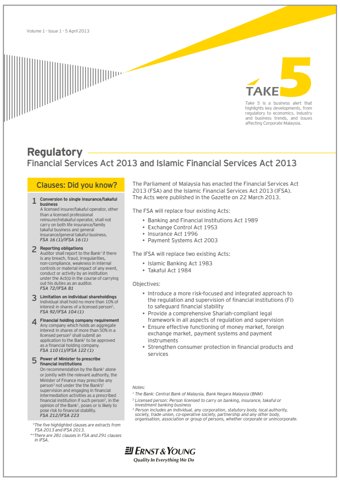
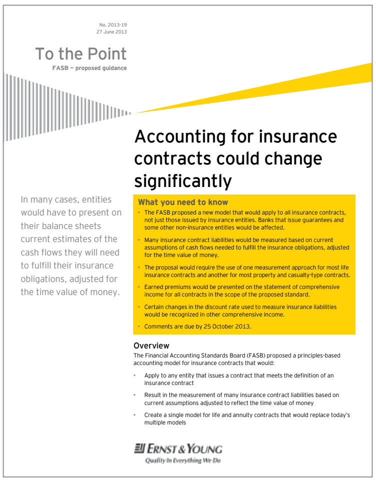
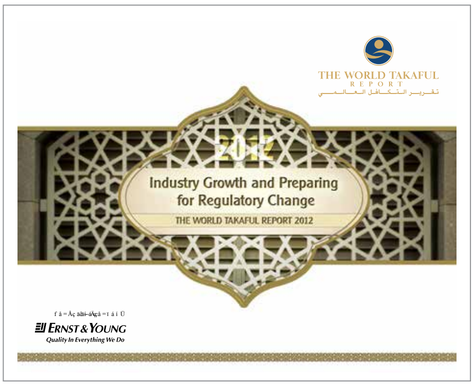
EY thought leadership







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