Market Review

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Sector
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Additional Information

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GCC: Rich in Potential, But Hurdles Remain

Top Middle East Markets Are Poised for Takeoff

Southeast Asia May Reward Shrewd Insurers, Punish the Careless

Criteria:
Takaful (Shari'a Compliant) Insurance Companies

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Takaful Poised for Growth, But Greater Focus is Required

Takaful operators in the Gulf Cooperation Council (GCC) and Malaysia are growing at a rapid pace and are enjoying strong capitalisation on a consolidated funds basis.

A.M. Best Co.'s research compares the performance of takaful operators to those of conventional insurers in the same markets. The findings indicate that:

- Family business is more profitable than general takaful, and is growing at a fast pace. Family takaful is also outpacing conventional life insurance, thereby representing the greatest opportunity for profitable growth of takaful operators.

- In general takaful, operators are growing quickly, but in most cases this is a consequence of the rapid expansion of the insurance markets in these countries, as opposed to increased demand for Shari'a-compliant offerings.

- Most general takaful operators tend to compete with conventional insurers on price because most start-up companies are falling behind their original business plans. Takaful operators' financial performance tends to be inferior to conventional insurers.

- Most takaful companies are highly capitalised. This is partly the result of many companies being in the early stages of operation and being capitalised at levels sufficient for when they would achieve operational maturity. In many cases, takaful funds have low levels of excess resources as these are retained at the operator/shareholder level.

- There are positive regulatory developments occurring in several markets, with the introduction of specific takaful regulation. However, in most countries there is considerable uncertainty as to the priority of liabilities in the case of insolvency of a takaful company. This could prove critical given the typically low levels of capitalisation of takaful funds.

A.M. Best believes takaful will continue to be among the fastest growing segments of the GCC and Malaysian insurance markets. The ability of takaful operators to increase insurance penetration is critical to their success. Family takaful currently presents the greatest opportunity to achieve this because it provides the Muslim population with alternative protection and investment opportunities, and the takaful insurers with increased profitability.

To ensure its longer term viability, the sector needs to improve its ability to retain earnings within the takaful fund and focus on product differentiation as opposed to competing on price.

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Competition Dampens Takaful Profits

The findings of this report are based on analysis of 131 takaful operators and conventional insurers operating within the Gulf Cooperation Council (GCC) – the United Arab Emirates (UAE), Bahrain, Saudi Arabia, Oman, Qatar and Kuwait – and Malaysia. All of the companies are followed by A.M. Best Co. and approximately one-third are takaful operators.

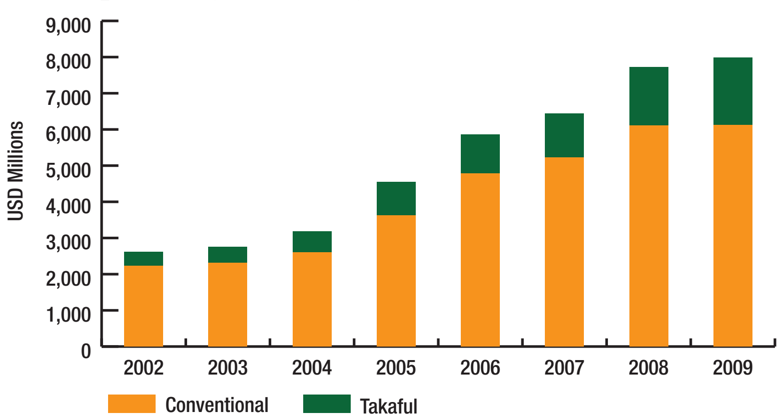
The data examines eight takaful operators and 45 conventional insurers in Malaysia. Malaysia is the second-largest insurance market in Southeast Asia and an international financial hub for Shari'a-compliant offerings. According to the insurance regulator, Bank Negara Malaysia, in 2010, general takaful contributions grew by 26.3% to MYR 1.4 billion (USD 454 million) while family contributions rose by 21.3% to MYR 3.3 billion (USD 1.1 billion).

While the takaful market has existed for many years in Malaysia, it is a relatively new development in the GCC. All companies operating in Saudi Arabia use a cooperative model, equivalent to a takaful structure. In 2009, the GCC's takaful contributions were estimated at USD 4.9 billion. This report looks at 31 takaful operators in the region and 47 conventional insurers.

There are significant market opportunities for takaful companies operating in the countries identified in this report. There are an estimated 17.1 million Muslims in Malaysia and 36.1 million in the GCC countries.

Exhibit 1

Takaful vs Conventional – General Insurance GWP* Development (2002-2009)



*Gross Written Premium

Source: A.M. Best Co., BestLink

Takaful's Market Positioning

The takaful market has grown significantly in recent years, benefiting from the introduction of compulsory covers in many of the countries it operates, and as clients gain a better understanding of its offerings. Governments in the GCC and Malaysia appear to support the concept of takaful, which provides Shari'a-compliant cover to people who otherwise may not have purchased conventional insurance.

Takaful operators have enjoyed strong growth in contributions in both the nascent and mature takaful markets. The majority of takaful business is general insurance, with family takaful accounting for less than 25% of the contributions received.

General takaful has grown at a compound annual growth rate (CAGR) of 27% from 2004 to 2009. Over the same period, family takaful has grown, on average, at a more modest 22%. However, when examining the performance of their conventional competitors in the same markets, which grew by only 5% annually over the same period, it is evident that family takaful operators are increasing their insurance penetration in their markets.

Strong Growth of General Takaful Business

Exhibit 1 shows that the general takaful business of the companies in A.M. Best's sample grew by an average rate of 27% from 2004 to 2009, with gross contributions of USD 1.86 billion. This outperformed the 19% rise in total premiums for conventional insurers in these countries.

The high growth rate of the sector is attributable in part to the market's growth from a low base. Takaful is a relatively new offering in the GCC, providing an option for a large part of the population that has previously been unable to purchase certain types of insurance owing to religious beliefs.

To an extent, general takaful has been buoyed by increased demand for protection in growing economies where compulsory lines of insurance have been introduced. In most cases, markets where takaful is offered are enjoying growth in gross domestic product (GDP) and increased consumer wealth which, in turn, has resulted in significant increases in insurance premiums for the market as a whole.

As a result, most takaful companies are competing with conventional insurers on pricing for the same business, rather than through a differentiated value proposition based on the ethical values of takaful.

Competition within personal lines probably will continue as the recent economic turmoil has resulted in the postponement of capital-intensive projects. Customers are likely to continue to purchase the most cost-effective product, as opposed to paying extra for an offering that is Shari'a compliant.

Takaful contribution volumes have increased sharply over the past few years; however, most takaful companies that have started trading in the past five years have fallen behind their original business plans. Companies with overly optimistic growth targets have revised their projections downward as an influx of new takaful companies coincided with the downturn in economic conditions. Some are still struggling to meet these new business plans.

Retakaful: Great Potential Fails To Materialise

In general, retakaful has also failed to grow as rapidly as initially expected. While there has been tremendous growth in the primary takaful market over the past few years, this has not translated into commensurate increased retakaful demand because takaful operators have been utilising traditional reinsurance capacity.

The majority of retakaful companies are consequently engaged in traditional reinsurance business. The growth of the retakaful market depends on whether primary takaful operators come under pressure to alter their reinsurance purchasing patterns and seek Shari'a-complaint cover for themselves.

Family Takaful Represents Best Opportunity

In general, life assurance is viewed as an opportunity for both conventional insurers and takaful operators. Family takaful business is more profitable than general takaful business, offering higher margins and stability, and is growing at a faster pace. This is a new market that is not served particularly well by conventional insurers.

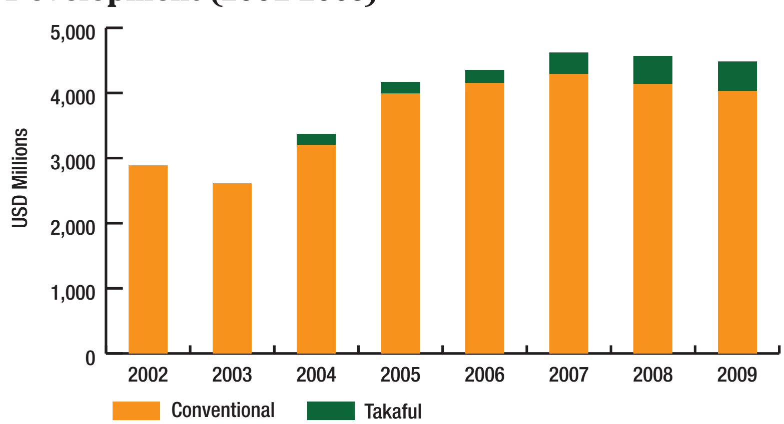
Exhibit 2 shows that family takaful premium of the sample companies grew by a 22% CAGR from 2004 to 2009 to USD 456 million, in particular driven by GCC premium development. Although this was from a low initial base, it was at a considerably faster rate than the conventional life market, which grew by 5% over this period.

Family/Life Premium Development

Family takaful premiums have grown particularly strongly in the GCC at an 86% CAGR over 2004 to 2009. The Malaysian market has a more developed takaful market and has experienced more stable growth in the past few years but again, takaful companies have outperformed traditional Malaysian life insurers.

Family takaful has also increased its presence over this six-year period. In 2004, the companies followed by A.M. Best in these markets represented 5% of the total family takaful and life market. In 2009, this figure had more than doubled to 10.2%.

Exhibit 2
Takaful vs Conventional – Family/Life GWP* Development (2002-2009)



*Gross Written Premium
Source: A.M. Best Co., BestLink

Family Takaful Delivers High Levels of Profitability

Family takaful has tended to be more profitable than conventional life insurance (see **Exhibit 3**). From 2002 to 2009, conventional life insurers have delivered a return on life premiums of 7.2% to 9.4%. Profitability of family takaful business tends to be more volatile owing to more aggressive and concentrated investment portfolios.

As a result, traditional life insurers outperformed their takaful competitors only during 2009 when return on life premiums was 7.3% for takaful operators, compared to 9.4% for their counterparts.

This was not a consequence of takaful operators' risk selection, rather a result of their asset composition with their investments being concentrated in sukuks (Shari'a compliant bonds) and private equity investments, which were among the hardest hit by the global downturn. A.M. Best expects that in 2011, the financial performance of family takaful operators will be higher than that of the conventional life insurers.

Higher profitability has been accompanied by upstreaming of profits to the operators' funds, with takaful operators consistently outperforming their conventional counterparts. This, if continued, will enhance the appeal of takaful business and its acceptance among the insured public.

Financial Performance of General Takaful Improves but Varied

The financial performance of takaful companies has improved, although this varies significantly between operators. Family takaful is very profitable while the profitability of general takaful depends on individual market and operator expertise.

In Malaysia, more stable growth has enabled takaful companies to post greater profits than takaful operators in the GCC. Malaysian takaful operators have also consistently outperformed their traditional competitors (see **Exhibit 4**), with combined ratios for takaful operators ranging from 93% to 74% in recent years.

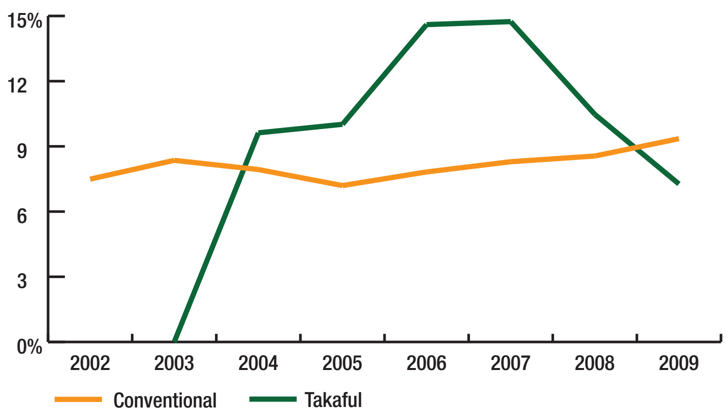
Profitability of General Insurance In the GCC

However, it has been a different picture for the GCC market where general takaful profitability has suffered from intense competition. The GCC has a younger takaful market, with most of the takaful companies being in the early years of their operations. The influx of new capital for the establishment of new takaful operators combined with the economic slowdown of recent years has meant that takaful operators need to compete on price in order to build up a presence and achieve the volumes anticipated in their original business plans.

While combined ratios have been below 100% since 2003, the financial performance of takaful operators is below those of conventional insurers in the GCC. In 2009, combined ratios were 87% for takaful

Exhibit 3

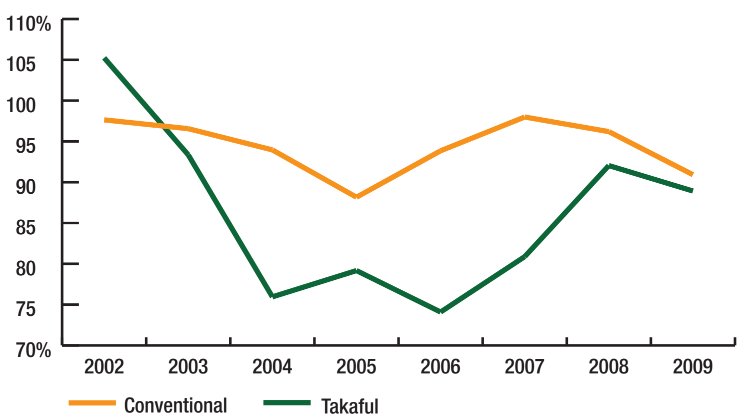
Takaful vs Conventional – Return on Family/Life Premiums (2002-2009)



Source: A.M. Best Co., BestLink

Exhibit 4

Takaful vs Conventional – Malaysia General Insurance Combined Ratio (2002-2009)



Source: A.M. Best Co., BestLink

companies, compared to 83% for conventional insurers (see **Exhibit 5**). It has been increasingly difficult to attract profitable business against the more established conventional insurers, which also benefit from high levels of reinsurance commissions received for the high risk business that they normally front.

As a result, general takaful business has been experiencing approximately 10 percentage points higher acquisition expense ratios. This, combined with the higher management expenses especially among start-ups, has resulted in operating expense ratios of 25% in 2009, compared to 19% for traditional insurers. This expense gap has been higher in prior years and has previously reached 15 percentage points higher than their traditional competitors.

Underwriting performance as measured by the claims ratio has remained remarkably close for conventional and takaful companies with a few companies in both sub-segments consistently deviating from the norm.

The difficulties that newer takaful entrants face in delivering technical profits pose a question as to their long-term viability. The willingness of their shareholders to continue to support these companies indefinitely will be tested if returns continue to lag behind original expectations.

Technical profitability will remain the most important driver for the viability and the rating of many takaful companies. However, with technical profitability lagging behind that of conventional insurers, investment performance becomes critical for the competitiveness of takaful operators.

Investment Performance Good But Volatile

In terms of asset allocation, most GCC and Malaysian takaful operators appear to follow the pattern of their domestic markets, having very similar proportions of asset classes as conventional insurers but with emphasis on sukuk investments as opposed to conventional fixed income and a higher exposure to private equity.

A.M. Best's analysis shows 57% of assets held by takaful operators were in higher risk investments such as shares (which include private equity), loans and real estate (see **Exhibit 6**). This is comparable to the asset mix of conventional insurers which have a similar investment in high-risk categories (61%); however, the conventional companies' investment in private equity is markedly lower, representing 27% of their share portfolio, compared to 36% for takaful companies.

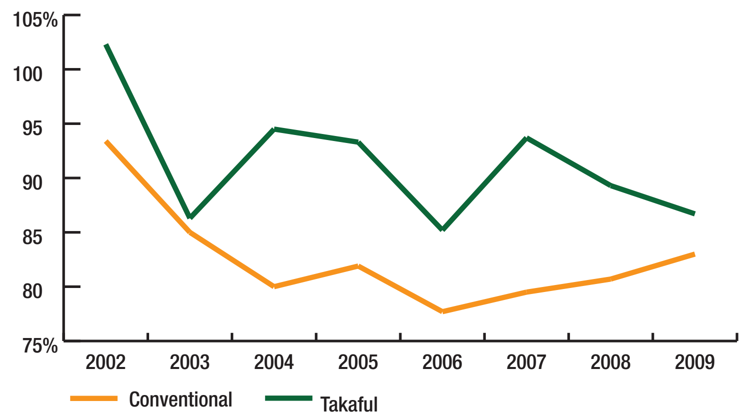
Investment Asset Mix Of Takaful Companies

Takaful market participants additionally face more restricted investment policies compared with their conventional counterparts. The supply of sukuk products in the market is limited in comparison with conventional bond offerings.

Therefore operators have a higher concentration of assets in their investment portfo-

Exhibit 5

Takaful vs Conventional – GCC* General Insurance Combined Ratio (2002-2009)

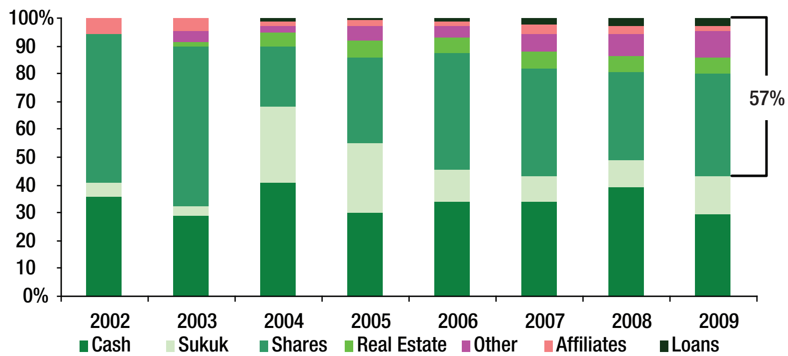


*Gulf Cooperation Council

Source: A.M. Best Co., BestLink

Exhibit 6

Takaful – Investment Asset Mix (2002-2009)



Source: A.M. Best Co., BestLink

lios. From 2004 to 2009, takaful companies have suffered greater capital losses, both realised and unrealised, in comparison to their conventional counterparts.

Since 2006, conventional insurers in the GCC and Malaysia have delivered a better return on their investments (see **Exhibit 7**). In 2009, takaful companies had an investment yield of 3%, compared to a 5% return for conventional insurers in the sample.

Excellent Capitalisation of Takaful Operators

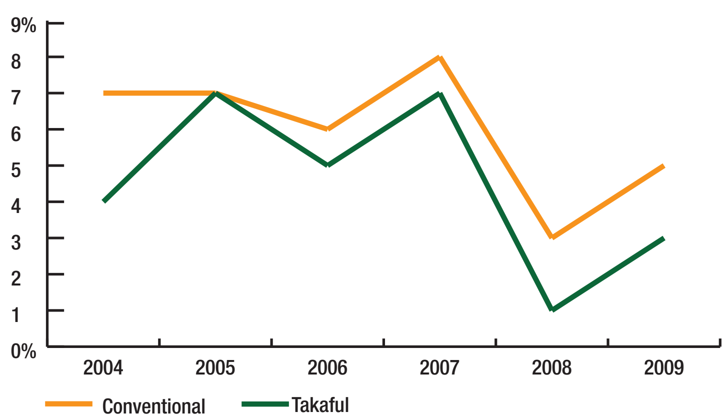
Both takaful operators and conventional insurers in A.M. Best's sample enjoy strong risk-adjusted capitalisations. In many cases, takaful companies have better capital adequacy than conventional insurers and local operations of international competitors. In part, this is a consequence of the early phase of their operating life and the fact that several start-up companies are failing to fulfil their initial business plans.

At the same time, capitalisation of takaful funds is kept low in most cases, especially among new operators. Most new companies that are generating any underwriting profits are delivering these to the operator's fund, resulting in a minimal retention in the takaful fund.

While this practice is viable in the short term, it creates uncertainty about the long-term prosperity of takaful funds. The building up of sufficient capital resources within the takaful fund is imperative for a secure A.M. Best rating, and the retention of earnings, especially in the early years of operation, is the only way for takaful funds to achieve their long-term viability.

Exhibit 7

Takaful vs Conventional – Investment Yield (2004-2009)



Source: A.M. Best Co., BestLink

In many cases there is a continuous dependence on the *qard hassan* (benevolent loan from the operator to the takaful fund). This can only be a short-term solution and at the same time, it brings to the fore the uncertainty surrounding the priority of policyholder liabilities in many takaful markets. In many cases there is no clarity as to the priority of policyholder liabilities, and often there is neither provision nor jurisprudence that would indicate the prevailing legal system (temporal versus Shari'a law) in case of the default of a takaful company.

Country Risk Improves In Takaful Markets

A.M. Best expects the operating environment to improve for most of the countries covered in this report, with the main driver being the rebound of most economies.

As part of A.M. Best's country risk rating methodology, countries are placed into one of five tiers, ranging from "CRT-1" (Country Risk Tier 1), denoting a stable environment with the least proportion of risk, to "CRT-5" (Country Risk Tier 5) for countries posing the greatest risk. All GCC countries and Malaysia have an A.M. Best "CRT-3," which is at the top end of the scale for emerging countries.

A.M. Best considers there to be positive developments in several markets because of the introduction of takaful specific regulation and minimum capital requirements, including in the UAE, Saudi Arabia, Bahrain and Malaysia.

As A.M. Best's primary focus is the assessment of financial strength and policyholders' security, the rationale and financial incentives on which the allocation of profits between policyholders and shareholders is based is of particular interest.

In many markets the seniority of policyholder claims remains unclear. Regulation has yet to be tested regarding the ring-fencing of assets within the takaful fund and the use of a *qard hassan* from operators, should the fund become insolvent.

An upstreaming of profits to the operator's fund by the younger takaful companies has resulted in several policyholder funds being significantly undercapitalised. Considering the continuing competitive nature of the market, in A.M. Best's opinion, this seems a precarious position.

The Islamic Financial Services Board's (IFSB) publication of the "Standard on Solvency Requirements for Takaful (Islamic Insurance) Undertakings" in December 2010 is welcome. The key principles and standards set by the IFSB, if adopted by local regulators and takaful operators, will provide additional security and uniformity. It is still unclear for many countries as to whether Shari'a or temporal law will take precedence in the event of a takaful operator becoming insolvent.

Many markets where takaful companies operate are considering implementing International Financial Reporting Standards. A uniform accounting standard is particularly welcome, as this would improve consistency and transparency among companies.

Takaful financial transparency has improved significantly over the past two years. However, there are still operators that fail to specify the financial performance of their funds. Furthermore, there is inconsistency as to how different funds are consolidated on the operator's balance sheet.

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