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Best's
Methodology and Criteria

Rating Takaful (Shari'a Compliant) Companies

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Outline

The following criteria procedure should be read in conjunction with *Best's Credit Rating Methodology (BCRM)* and all other related BCRM-associated criteria procedures. The BCRM provides a comprehensive explanation of AM Best's rating process.

A. Market Overview

Despite many similarities between takaful (Shari'a compliant insurance) companies and conventional insurance companies, takaful companies have distinctive features that need to be highlighted within the AM Best rating process.

As part of its corporate governance framework, a takaful company must establish a Shari'a board that provides oversight and sets the rules and principles governing its activities, ensuring that it operates within Shari'a principles. Whilst AM Best does not specifically comment on a takaful company's degree of compliance with Shari'a, the following items are subject to discussion:

- the organization's corporate and management structure;
- the type of takaful business model employed;
- corporate governance and the role of the Shari'a board; and
- the takaful company's performance versus key strategic and financial objectives.

Principles of Takaful

Takaful includes both general (non-life) and family (life) products. The family product line includes life and health insurance, as well as education, accident, and travel medical plans. The existence of takaful companies is a result of the commonly accepted incompatibility between Islamic beliefs and the conventional insurance model.

Takaful is essentially a cooperative risk-sharing program established for the well-being of the community. The purpose of this system is not to generate profit, but to uphold the Islamic principle of Al-Takaful (a pooling system to guarantee against loss or damage). As a result, takaful is based on the concept of mutual cooperation, solidarity, and brotherhood. Takaful participants contribute (donate) to help protect one another against the impact of unpredicted risk and catastrophe, whereas in the conventional insurance model, policyholders pay premiums to an insurance company that protects them, or their interests, from some form of risk.

Other Islamic beliefs or principles that takaful operations intend to address are the avoidance of both uncertainty—particularly in terms of the amount and timing of claim payments to be made—and excessive profit, which is seen as usury—be it in the form of payments received in the event of death, or any form of financial interest (e.g., bond coupon payments).

Underwriting and actuarial techniques apply in a similar manner as under conventional insurance, in that the takaful company evaluates the risk of potential loss and establishes a contribution (premium) base appropriate for that aggregated risk to protect the pool from undue losses. However, unlike the risk-based premium paid by a policyholder in a traditional insurance model (where each insured pays a rate commensurate with specific rating factors), each takaful participant shares in supporting the pool in recognition of the underlying principle of mutual cooperation.

Similarly, the takaful company's reinsurance cover should also be based on the pooling concept. The reinsurer should act primarily as a risk manager (retakaful operator) and should not profit excessively from the underwriting results. However, because of the relative lack of capacity and quality of true retakaful carriers, reinsurance with conventional reinsurers may be permitted by the Shari'a board under particular conditions and limitations.

Takaful Models & Structures

There is not one preferred operating model for takaful companies. Shari'a scholars generally agree on certain fundamental components that are required to be an accepted takaful company; however, operational differences are tolerated as long as there is no contradiction to any essential religious tenets. There are currently three primary operating models: the Al Mudharabah model, the Al Wakalah model, and the Waqf model.

Ta'awuni Concept

The Ta'awuni concept (cooperative insurance) practices the approach of pure Mudharabah in daily transactions by encouraging the Islamic values of brotherhood, unity, solidarity, and mutual cooperation. In the pure Mudharabah approach, the takaful company and the participant share the direct investment income, while the participant is entitled to 100% of the residual surplus in the policyholders' fund, with no deduction made prior to the distribution.

From the Ta'awuni concept, there are two basic models, Al Mudharabah and Al Wakalah. In reality, there are many variations of these basic models, but these variations fundamentally follow one of these two conceptual frameworks or combine them in a hybrid model.

Al Mudharabah Model

This is a modified profit- and loss-sharing model. The participant and the takaful company share the residual surplus. Such profit (surplus) is shared based on a ratio mutually agreed between the contracting parties. Generally, these risk-sharing arrangements allow the takaful company to share in the underwriting results from operations, as well as the performance returns on invested premiums.

Al Wakalah Model

This is a fee-based model. Cooperative risk-sharing occurs among participants where a takaful company simply earns a fee for services (as a Wakeel, or "Agent") and does not participate or share in any underwriting results. The takaful company's fee may include a fund management fee and a performance incentive fee.

Waqf Model

Unlike the Al Mudharabah and Al Wakalah models, the Waqf model operates as a social/governmental enterprise, and programs are operated on a non-profit basis. Under the Waqf model, the surplus or profit is not owned directly by either the takaful company or the participants, and there is no mechanism to distribute the surplus funds. In effect, the takaful company retains the surplus funds to support the participant community. The Waqf model, with a single surplus fund, is most like a mutual insurance model.

The remainder of this criteria procedure will highlight the unique elements of takaful companies following the Ta'awuni model—since this is by far the most common amongst rated companies—and how these factors are incorporated in the rating analysis.

Takaful Windows and Subsidiaries

Conventional insurers may elect to use takaful windows—which are not, by definition, separate legal entities, but a ring-fenced fund within the company—or takaful subsidiaries in order to widen their offerings and service clients. These entities will be evaluated as part of the standard rating process.

Main Characteristics of Takaful Companies

Takaful companies have certain unique characteristics that recognize the key principles of Al-Takaful and fundamental Islamic beliefs.

Two Separate Funds

One significant characteristic of a takaful company is the existence of two separate funds, a takaful (or policyholders') fund and an operator's (or shareholders') fund. The takaful fund operates under pure cooperative principles. Underwriting deficits and surpluses are accrued over time within this fund, to which the operator has no direct recourse. As a result, the takaful fund is conceptually ring-fenced and protected from default of the operator's fund. Management expenses and seed capital are borne by the operator's fund, where the main income takes the form of either a predefined management fee (usually called a Wakalah fee) to cover costs or a share of investment returns (called a Mudharabah fee) and underwriting results (or a combination of both).

Solidarity Principle and Equal Surplus Distribution

Given the fact that the takaful fund is seen as a pool of risks managed under solidarity principles, it is not meant to accumulate surpluses at levels excessively higher than those strictly needed to protect the fund from volatile results and to support further growth. Likewise, any fees or profit shares received by the operator should be just sufficient to cover management and capital costs while keeping the company running as a going concern.

In case of policyholder deficit within the takaful fund, in most cases the operator is committed to providing it with an interest-free loan (Qard' Hasan), for however long it is deemed necessary, thus providing an additional layer of financial security to the participants. The Qard' Hasan is likely to be limited to the available capital in the operator's fund or a prescribed limit. In some cases, a Qard' Hasan may not exist, as deficits are directly written-off against shareholder's (operator's) equity.

The surplus distribution structure is expected to be managed carefully and in a balanced way, so that neither policyholders nor the operator makes excessive profits at the expense of the other party.

Restricted Investments

Shari'a compliance refers not only to the operational structure of the company, but also to its investment policy. Takaful companies must avoid investing in traditional fixed-income securities due to the coupon interest payment attached. Instead, they are allowed to invest in sukuk, which are Islamic bonds where coupon payments take the form of a profit share on a particular enterprise. Moreover, investments in stocks, which are in principle allowed, should avoid financing non-Islamic activities (such as alcohol or gambling).

In practice, these restrictions often translate into a concentration in stocks (due to the relative scarcity of sukuk), lower than average credit ratings of sukuks and high geographical concentration. AM Best has also observed takaful companies maintain high allocations to cash and cash equivalents, reflective of investment opportunity limitations.

Establishment of a Shari'a Board

An essential component in a takaful company's corporate governance is the establishment of a Shari'a board, in addition to the conventional board of directors. The Shari'a board consists of recognised Islamic scholars who ensure the company's operational model, profit distribution policies, product design, and investment guidelines comply with Islamic principles.

The global shortage of recognised Islamic scholars in the insurance arena and lack of consensus regarding what constitutes Shari'a compliance is, in AM Best's view, a challenge for a more rapid development of the industry. The emergence of some inter-regional and government-supported initiatives, as well as the participation of individual scholars in more than one Shari'a board, are positive signs of a gradual but slow trend toward convergence.

AM Best's Rating Process

The building blocks of AM Best's rating process are outlined in **Exhibit A.1**.

Exhibit A.1: AM Best's Rating Process

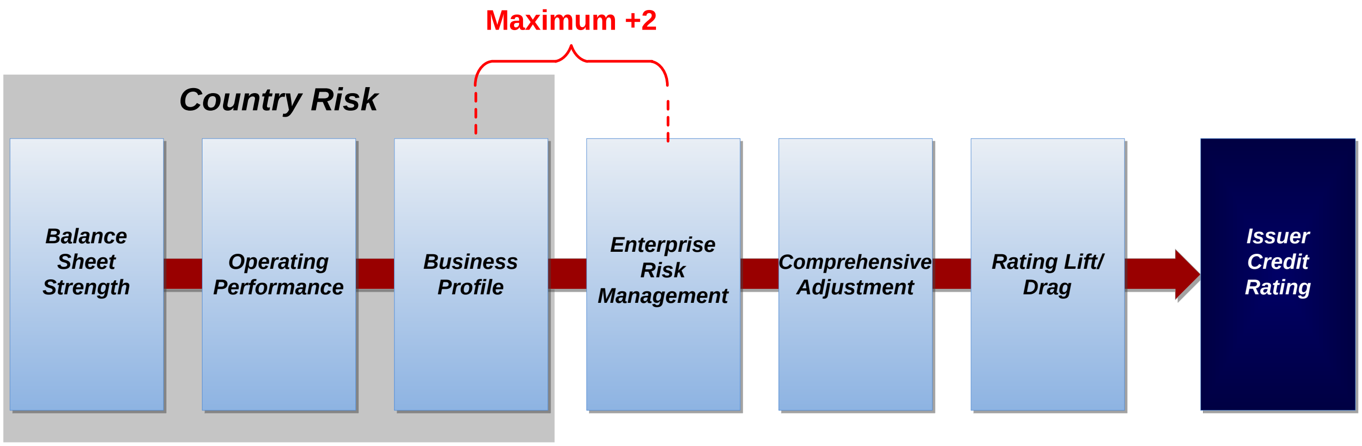


Exhibit A.2 details the assessment descriptors for the evaluations of balance sheet strength, operating performance, business profile, and enterprise risk management.

Exhibit A.2: BCRM Building Block Assessments

Balance Sheet Strength	Operating Performance	Business Profile	Enterprise Risk Management
Strongest	Very Strong	Very Favorable	Very Strong
Very Strong	Strong	Favorable	Appropriate
Strong	Adequate	Neutral	Marginal
Adequate	Marginal	Limited	Weak
Weak	Weak	Very Limited	Very Weak
Very Weak	Very Weak		

The specific considerations of takaful companies within the building block assessments are discussed in the following sections.

B. Balance Sheet Strength

Takaful companies have certain limiting features inherent to their business model, such as a relative lack of financial flexibility compared with stock companies, or increased concentration risk compared with broadly diversified insurers. This section discusses some unique elements of takaful companies and how these are assessed in the rating process.

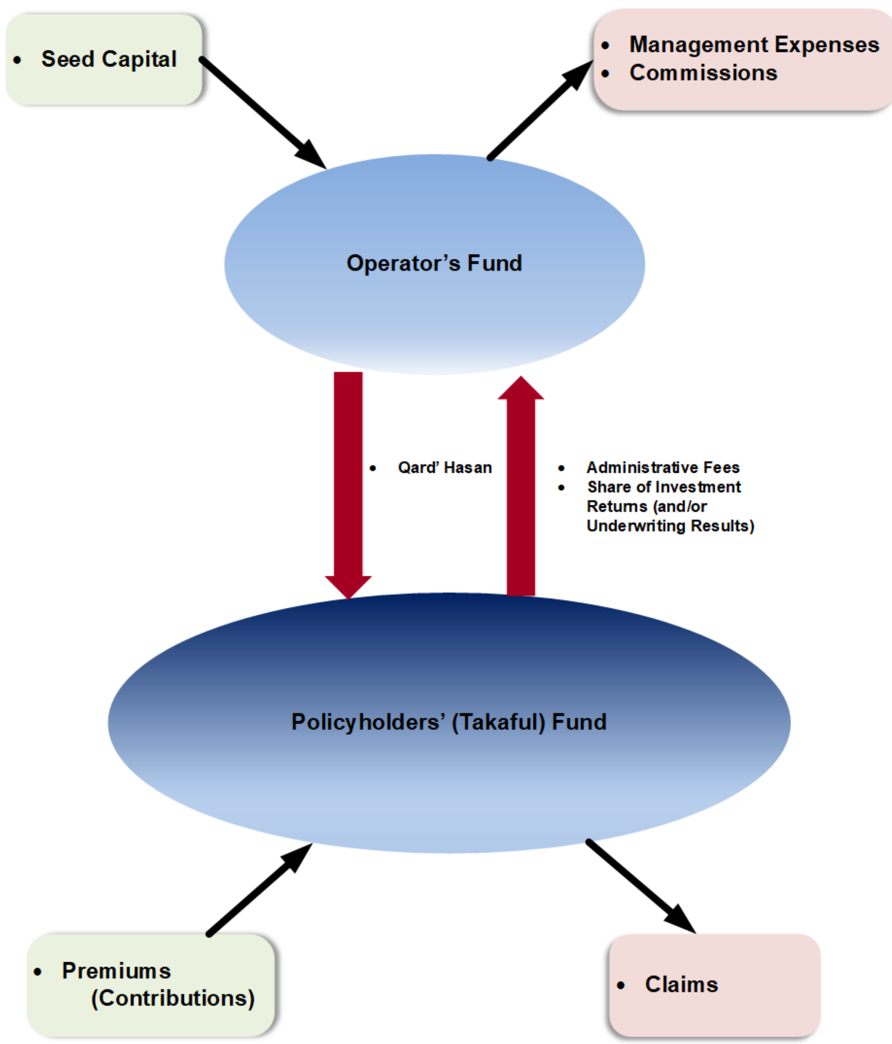
Two Separate Funds: A Two-Stage Risk-Based Capital Approach

One of the primary quantitative measures used to evaluate the financial strength of a takaful company is the Best's Capital Adequacy Ratio (BCAR).

Subject to regulatory enforceability as to the need for the shareholders' fund to support the policyholders' fund, the first-tier analysis of the takaful fund involves calculating its net required capital—the capital required to support the fund's obligations to participants at different confidence levels—and determining the capital it has available to support these risks. The BCAR scores for the takaful fund, as well as an analysis of the trends in the scores and other key metrics contribute to AM Best's assessment of the takaful company's balance sheet strength.

A second-tier capital assessment also is performed on a combined basis, including both the shareholders' fund and the operator's fund. The second-tier analysis uses the combined capital position of both funds to arrive at a determination of the capital available to support these risks at different confidence levels.

Exhibit B.1: Basic Takaful Model



A combined position, (i.e., both takaful fund and operator's fund) with much higher financial flexibility than its corresponding takaful fund normally will enhance the balance sheet strength assessment with respect to the whole takaful operation, reflecting the increased financial strength provided to the takaful fund's participants. This enhanced balance sheet strength stems from the operator's obligation to provide an interest-free loan (Qard' Hasan) to the takaful (or policyholders') fund in situations of policyholder deficit. In cases where such a loan has been made to the takaful fund, the loan will be considered part of the takaful fund's capital base. Additionally, in circumstances where the potential Qard' Hasan (dependent on strength of regulation) is not sufficient to bring the takaful fund to cover policyholder obligations, consideration will be given for shareholders' commitment to the takaful fund, such as ring-fencing of assets in favor of policyholders.

This consolidated view of capital, in effect combining the takaful and operator's fund for analytical purposes, is particularly important in the assessment of takaful companies in the early years of operation. For companies with a short track record, it is not uncommon for the operator's fund to be in a stronger relative position, as takaful funds tend to have low levels of accumulated surpluses.

A combined assessment weaker than the one applied exclusively to the takaful fund may not detract from the overall analysis significantly, as long as the key assumption—that the operator's fund cannot access the takaful fund's surplus—holds. Regardless of which fund is in a stronger relative position, it is important to note that this two-tier analysis is supplemented by a comparison of the capital accumulation trends in each of the separate funds to ensure an appropriate balance in the surplus distribution and fee structure.

Regulatory Concerns and Capital

The strength of regulation varies significantly among jurisdictions, and, without a solid track record the protection to policyholders is somewhat unclear. While regulation of takaful companies has improved in recent years, there remains an inherent lack of transparency in certain jurisdictions, particularly concerning the liabilities on winding up a takaful company. Where regulation is deemed to be weak or unclear, credit can be given for additional commitments to the takaful fund from shareholders, such as ring-fenced assets, or explicit policy wording regarding the ability of the operator to support the takaful fund through Qard' Hasan. Additionally, AM Best will consider the role of the Shari'a board within the organization and any potential differences with regulators on winding up a company.

Moreover, in AM Best's opinion, some of the regulatory safeguards— such as ring-fencing of assets within the takaful fund, interest-free loans from operators in case of solvency difficulties, and other mechanisms—are yet to be tested. The evolution of the takaful sector in general, including the regulatory environment, needs to keep pace with the rest of the Islamic financial industry (especially banking).

Depending on the strength of the takaful regulatory environment, AM Best may focus only on the combined BCAR assessment, reflecting the degree of comfort regarding the level of shareholder support with respect to policyholder liabilities.

Main Drivers of Balance Sheet Strength in a Takaful Company

Given the comparatively restricted investment policy of a typical takaful company, its consequent higher levels of counterparty risk, geographical concentration, and higher than average proportion of stock holdings, investment risk tends to be a source of negative pressure in the balance sheet strength assessment.

The narrow range of Shari'a-compliant investment opportunities available to takaful companies accounts for their visible concentration in particular asset classes. At the same time, these limited opportunities usually restrict the development of more long-term products, due to the difficulty in addressing asset-liability management issues. The current situation has shown some improvement as the capital markets in Islamic countries continue to develop and more Shari'a-compliant investment products become available in the market.

An essential feature of all takaful models is the participants' sharing of the underwriting surpluses/deficits. Accurately determining the surplus/deficit is, therefore, fundamental to the accounting process. Setting aside a reserve for contingencies always raises the question as to which policyholders own it, i.e., the participants that contributed in earlier years or later generations. This is relevant because the requirement for reserve development in the initial years of takaful operations is likely to be substantially greater than in subsequent years. This effectively will result in earlier participants paying to stabilize underwriting results for later participants.

Despite the possible inequity in a pure sense, the building up of a surplus in the policyholder fund is desirable to make it practical to expand the size of the risk pool (as there will be limits to what amounts the takaful operator will be able to provide as Qard' Hasan in case of deficits). As with conventional insurance operations, an important assessment factor is the takaful company's degree of financial flexibility, i.e., the company's ability to raise equity capital. The capital available typically would be expected to reflect significant surpluses accrued over the years within the takaful fund. This component of the analysis is focused mainly on the operator because of the nature of the takaful fund and its inherent lack of financial flexibility. The assessment generally involves a detailed analysis of the ownership structure (and shareholders' solvency) and the record of equity or debt issues. The assessment also considers the shareholders' capital commitment to the takaful fund.

AM Best monitors carefully the quality of the reinsurance program to assess a takaful company's degree of balance sheet protection. This is particularly relevant given the previously mentioned restricted retakaful capacity (and virtual nonexistence of retro-takaful), which may force direct takaful operators to utilize conventional reinsurance capacity.

C. Operating Performance

As noted, the purpose of the takaful system is not to generate excessive profits. At the same time, in principle, any fees paid to the operator on average should be lower than the difference between premiums and claims. In other words, as long as the takaful fund continues to generate surpluses in the long term, there should be no major reason for concern. Having satisfied this condition, AM Best believes that to ensure the ongoing existence of the whole takaful operation, it is important that the operator at least can cover its expenses from the fees received from the policyholders' fund. Additionally, the takaful fund should generate sufficient profits to sustain itself and there should be a suitable balance of profit distribution between shareholders and policyholders, along with appropriate management fees to generate surpluses. This is particularly the case for those takaful companies that would expect to receive an operating performance assessment of at least "Adequate".

Typically, takaful companies (particularly in the Middle East) show higher expense ratios than their conventional counterparts. As the sector matures, an appropriate balance should develop between fees that reflect the combined level of expenses plus cost of capital and the ability to build surpluses within the takaful fund.

Given takaful companies' constraints in asset management, higher concentration in certain investment classes and in a particular geographical region, combined with increased counterparty credit risk, AM Best expects takaful funds, on average, to yield lower risk-adjusted returns, and experience higher volatility and credit defaults. Despite the sustained growth in the supply of Islamic securities, AM Best believes the investment opportunities are likely to remain limited, especially within the Middle East.

D. Business Profile

A material component of the rating process focuses on the business profile of the company, including its diversification with regard to its client base, business lines, and distribution network. Given the developing stages of the takaful sector and narrower profiles of takaful operators, in many cases the business profile assessment will be "Limited".

The typical size of a takaful company remains smaller than that of a conventional insurer operating within the same market. This is in part a result of takaful companies' relative lack of track record (takaful operators have only been in existence since 1979), and the more limited profile of takaful companies when compared with conventional insurers that have diverse operating platforms and a long running history.

AM Best believes it is not yet clear whether takaful companies offer a significant competitive advantage, as untapped demand (especially in family/life insurance business) due strictly to religious beliefs remains to be seen.

E. Enterprise Risk Management (ERM)

Takaful-specific regulation is extremely important in AM Best's enterprise risk management (ERM) assessment of takaful companies. In AM Best's view, a robust regulatory regime is crucial for the advancement of enterprise risk management. AM Best also believes that, given their constraints, takaful companies need to demonstrate they can apply a sufficient risk-based approach to the following:

- Investment management (because of the reduced investment opportunities);
- Capital adequacy and reserving (given the need for building up surpluses in the long term, especially for family/life business); and
- Pricing/adverse selection control (given the restrictions on charging extra risk premiums for policyholders representing a greater risk of loss than the aggregate participant pool).

Rating Takaful (Shari'a Compliant) Companies

AM Best acknowledges that takaful operations face an additional layer of complexity when developing a suitable ERM framework, given the existence of two separate funds.

Overall, one of the unique challenges facing takaful companies is ensuring that there is an appropriate balance between the objectives set by their Shari'a boards and the trends shown by their key financial performance indicators. This includes establishing processes to address all material risks, despite the challenges presented by the limited capacity of retakaful, along with the concentration risks presented by restrictive investment guidelines and the limited geographic diversity of the current takaful marketplace.

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