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Al-Ānqsām Opalesque

Featured Structure
How Conventional Insurance and Takaful Differ Numerically
Mohammed Amin

Lex Islamicus
Ibra': Should it be Discretionary?
Marjan Muhammad and Hakimah Yaacob

The Islamic Window
Young but Disconnected
Joy Abdullah

Islamic finance is riddled with dichotomies, it is almost natural to approach it in terms of good and bad, right and wrong, halal and haram. The reality however is sometimes not as clear cut, and we explore many of these dichotomies (and some of the ensuing gray areas) in this the tenth issue of Opalesque Islamic Finance Intelligence. To start off our editorial note surveys a variety of research taken from the conventional finance world and how this relates to Islamic finance. This is promptly followed by our featured resource, which lists several of these academic studies.

We welcome Mohammed Amin in our Featured Structure section as he shares a descriptive analysis of takaful and how it differs with conventional insurance. Similarly, Lex Islamicus hears from Marjan Muhammad and Hakimah Yaacob, from the International Shari'ah Research Academy (ISRA), as they scrutinize the application of Ibra' and whether it should remain discretionary or mandatory in contractual agreements.

The Kulliyyah Korner profiles the work from Mobasher Zein as he has explored various areas of Islamic finance (from sukuk to hedge funds), whereas Joy Abdullah provides food for thought in the Islamic Window segment by looking into how Islamic values can be brought into the branding of Islamic banks and their products.

Blake Goud takes on our Opinion Column with his analysis of the recent publication by Zaid Ibrahim & Co entitled "Demystifying Islamic Finance" and the various issues that are tackled within. Last but not least, our Industry Snapshot section sees Omar Clark Fisher delving into corporate governance issues faced by the Takaful industry.

As always, we are keen to hear your comments & suggestions and remember that you can visit our online archive (see reference link) for access to our ever-growing databank of Opalesque Islamic Finance Briefing as well as all of the back issues of Opalesque Islamic Finance Intelligence.

Best Regards,
Bernardo
Editor, Opalesque Islamic Finance Intelligence

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Conventional Wisdom

By Bernardo Vizcaino, CAIA

A Twisted Sister?

They seem to be forever at odds with each other, almost by default we consider Islamic finance as being diametrically opposite to conventional finance (at least conceptually that is). Theirs is the story of two rival siblings who appear to have no willingness to reconcile their differences. This is a family feud made even harsher if one regards them as next door neighbours who are forced to share the same backyard: both having to answer the same market challenges and compete for the same financial opportunities.

Despite their differences (some irreconcilable) can we inquire whether a young (almost pre-pubescent) Islamic finance can learn from the older (almost venerable) conventional finance? Can these two sisters learn from each other, even though it is unlikely they will never get along? Or is it that everything related to conventional finance is completely negated by its indulgence in interest-bearing securities and other non-permissible activities?

While conceptually different, this does not suppress everything there is to know about conventional finance. In fact it would be rather callous to discount everything that the older sister has done (or avoided doing), and in particular to overlook some key practices and methods. Sure, the recent past has brought the spotlight on some of its most pervasive failings (in a most spectacular fashion I might add). Nevertheless, conventional finance, in all its wickedness, has amassed over the years a significant body of academic work covering almost every imaginable permutation (from macroeconomic trade flows of the Japanese Yen to how subtle moves in the stock market can be explained by which day of the week it is).

This extensive research history has managed to highlight, promote, scrutinize, defeat, chastise, berate and even ridicule many practices of conventional finance. This of course is a good thing, since it is this constant (and in some cases relentless) examination that has allowed for refinements, prompted improvements, and triggered the occasional overhaul. These studies cover almost every imaginable scenario - from evaluating the cost-effectiveness of indexation products, challenging the uncorrelated nature of alternative investments, scrutinizing the independent nature of rating agencies, to analyzing litigation outcomes relating to the marketing of structured products to retail investors.

Work on the latter was published by Nera Consulting (see reference link), which is an eye-opener for those studying the implications of unleashing structured products for mass consumption. At first glance this would not seem not have anything to do with Islamic finance. However, various regulators are having to contend with the introduction of rather complex Shariah compliant instruments into their capital markets, with clear implications when there is an unprepared retail market.

On the other hand, this conventional research has supported various concepts akin to Islamic finance; this is especially true as it relates to equity investing and more specifically equity-screening. Hence we have numerous studies relating to socially responsible investing, analyzing whether such screened investing is viable and whether investors should be willing to accept a financial penalty (i.e. higher costs or diminished returns). The firm Phillips, Hager & North has done an excellent survey of the existing SRI literature (see reference link) and the paper has a very comprehensive table summarizing the key findings from many of these studies (not included here due to space constraints, although most of the quoted studies are included in our Featured Resource section). Much of this research validates the concept of equity-screening and empirically proves that ethical investing does not necessarily entail lower returns.

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Editor's Note

Look What the Cat Dragged In...

On the other hand, it is rather curious that Islamic finance is but an after-thought in many of these papers, in some it is relegated to the footnotes and for others it seemingly does not exist. Why? Are Islamic funds not regarded as ethical? Are the equity-screening methodologies of Islamic funds not 'religious' enough? Perhaps it is due to the fact that - until recently - data providers have done an absolute miserable job at surveying Shariah compliant products, and hence they went unnoticed/unreported? Or is there a more sinister explanation: has western-focused academia inadvertently overlooked Islamic finance? Worst still, has this been on purpose – has Islamophobia spilled over to academia to create an Islamic-finance-ophobia of sorts?

I'm well aware that this is a serious accusation, but it wouldn't be the first time that the SRI industry has been caught with its pants down. After all, it has given a blind eye to microfinance for many years (if not decades); its output as it relates to interest-free finance is close to nothing; it has had to respond more than once to the spectre of high management fees; and it has been rather inconsistent with regards to sustainability and social-engagement. In fact, prior to the financial crisis, the typical SRI fund would have devoted almost 25% of its holdings to the financial services sector. Little has been heard from the SRI industry regarding responsible lending initiatives - or for that matter shunning predatory lending practices.

Even more remarkable, an Asian-based SRI firm much prefers to talk about some random climate change product (presumably fee-rich) rather than the overwhelming output that is being generated from countries such as Malaysia, Singapore and Indonesia in terms of Islamic banking products. Strikingly, this firm reports that there is ONE ethical fund in Indonesia (even the lousiest of data providers can shed light on a handful of Syariah mutual funds, well over 30 if you care to look for them properly). No laughing matter, Islamic finance is ethical, it is socially responsible, it must be recognized by the SRI industry in an upfront manner (not hidden somewhere in an appendix).

Fortunately, I can be proven wrong with multiple examples of far more professional research, from Italian academics analyzing 'Islamic Mutual Funds as Faith-Based Funds in a Socially Responsible Context" (see reference link) to the more technically-oriented (and Scottish-based) scrutiny of 'Islamic Mutual Funds' Financial Performance and Investment Style' (see reference link). While these (and many other) works don't seem to appear as often as the should they must be commended, dusted out from the bookshelves and follow-up studies should be encouraged more than ever.

The Quiet Riot

The industry does have an existing body of academic work, although this output mostly pertains to Islamic economics and not the more specific subset of Islamic banking & finance. Accordingly, the literature of the former has been focused on the macroeconomics of it all (profit and loss sharing mechanisms, the gold dinar as a currency, as well as other structural aspects). For a more thorough review see Asad Zaman's 'Islamic Economics: A Survey of the Literature' (see reference link).

Then again, we are witnessing a rejuvenated academic output in Islamic finance from the likes of BIBF, INCEIF, ISRA, and multiple universities and educational bodies from across the globe. At first glance they appear to be a motley crew of seemingly disjointed academic output, quietly toiling from the background. Nevertheless, they are all reflective of a revivalist and in certain ways a revisionist trend in Islamic finance research. Moreover, they might have governmental or institutional support but it is a new generation of academics and practitioners that is proving to be its most energetic fuel. Hence it might be very soon that we find Islamic finance boasting as vast a literature as many other industries. They will borrow from past research, scrutinize it, challenge it and polish it. We can take notice but most importantly we should encourage it as much as we can.

Your feedback and comments are very important to us, please feel free to contact the author via email.

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Conventional Wisdom

Blogger™ As Featured in the Islamic Finance Resources Blog

There is much that one can learn from the world of conventional finance, this is true for its many success stories as well as its most blatant failings. Featured below is a short selection of some of the most quoted and/or noteworthy research from recent years:

Cleaning a Passive Index: How to Use Portfolio Optimization to Satisfy CSR Constraints
Moshe A. Milevsky, Andrew R. Aziz, Allen Goss, Jane Thomson, David Wheeler
December 2004

Does Ethical Investment Pay?
Ross Havemann, Peter Webster
September 1999

Evaluating the Performance of Ethical and Non-Ethical Funds: A Matched Pair Analysis
N. Kreander, R. H. Gray, D.M. Power, C. D. Sinclair
September 2005

Guidelines for Integrating Socially Responsible Investment in the Investment Process
Frank Jan De Graaf, Alfred Slager
September 2006

International Evidence on Ethical Mutual Fund Performance and Investment Style
Rob Bauer, Rogér Otten, Kees C. G. Koedijk
March 2002

Investing in Socially Responsible Mutual Funds
Christopher Geczy, Robert F. Stambaugh, David Levin
October 2005

Is there a Difference? The Performance Characteristics of SRI Equity Indexes
Michael Schröder
July 2005

Measuring The Performance Of Ethical Mutual Funds: A DEA Approach
Antonella Basso, Stefania Funari
January 2002

Socially Responsible Investing and Management Style of Mutual Funds in the Euronext Stock Markets
Auke Plantinga, Bert Scholtens
May 2001

Socially Responsible Investing in the Global Market: The Performance of US and European Funds
Maria Ceu Cortez, Florinda Silva, Nelson Areal
February 2009

Socially Responsible Investment Screening: Strong Evidence of No Significant Cost for Actively Managed Portfolios
Bernell K. Stone, John B. Guerard, Jr., Mustafa N. Gultekin, Greg Adams
June 2001

Socially Responsible Investments in Germany, Switzerland and the United States : An Analysis of Investment Funds and Indices
Michael Schröder
September 2003

Socially Responsible Investments: Methodology, Risk Exposure and Performance
Jenke Ter Horst, Chendi Zhang, Luc Renneboog
June 2007

Socially Responsible Investors and Their Advisors
Meir Statman
November 2007

The Cost of Socially Responsible Investing
Tim Adler
May 2008

The Cost of Socially Responsible Portfolios: Testing for Mean-Variance Spanning
Rients Galema, Auke Plantinga, Bert Scholtens
February 2009

The Determinants of Sin Stock Returns: Evidence on the European Market
Julie M. Salaber
November 2007

The Ethical Mutual Fund Performance Debate: New Evidence From Canada
Rob Bauer, Jeroen Derwall, Rogér Otten
January 2007

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How Conventional Insurance and Takaful Differ Numerically

By Mohammed Amin

Mohammed Amin is an Islamic finance specialist, with a particular interest in how Islamic finance is treated in Western tax and regulatory systems. He is a member of the HM Treasury Islamic Finance Experts Group, established by the Economic Secretary to the Treasury to advise the Government on Islamic Finance strategy, and is the only practicing accountant on that group. Until he retired at the end of 2009 Amin led PricewaterhouseCoopers' Islamic Finance practice in the UK as well as being a member of PwC's four-person Global Islamic Finance Leadership Team. He shares his thoughts on Muslim community issues and Islamic finance topics on his website (see reference link).

Insurance is a key financial service in all advanced economies. There are very few people who choose to live without any form of insurance cover. For certain activities, such as driving a car, insurance is compulsory in the UK. However, outside the insurance industry there is a surprising lack of knowledge of how insurance actually works. Meanwhile takaful (usually described as the Islamic equivalent of insurance) is relatively new and even less widely understood.

One of the difficulties in understanding insurance is the complexity of the industry, the arcane terminology used and the extensive regulations governing insurance business. Theoretical physicists, when faced with similar complexity often commence by analysing a much simplified hypothetical case, and then consider what can be generalised to the real world. Isaac Newton could never have found real point masses moving without frictional constraints, but his theoretical analysis of them led to his laws of motion and to Newtonian mechanics. In a similar (but humbler) vein, I would like to consider insurance and takaful from first principles. In the case of insurance, all one needs to think about is one person who is exposed to risk. In the case of takaful, which involves mutual sharing of risk, one needs to think about a minimum of two people who share risk with each other.

In this minimalist vein, assume there are two individuals concerned about the risk of house fires, Abdul with a house worth $1m and Bilal with a house worth $100,000. Both also have significant amounts of cash savings, $1m in Abdul's case and $100,000 in Bilal's case. They also have a very wealthy friend, Chowdhury, who is willing to take on risks for a fee, and has the money to honour his commitments. Chowdhury charges 0.1% of the value of the house per year, and it is assumed that this represents the statistical likelihood of loss. In other words, if we had a large enough sample of houses, 0.1% of the total value of the houses would disappear in fire losses each year.

Let us consider a period of one year, when a house fire either happens, with total destruction of the house concerned, or does not happen.

(A) Example 1 - Abdul with no risk transfer

Assume that Abdul buys no insurance. A fire may or may not happen.

Scenario 1 - No Fire

	Before	After
House	$1,000,000	$1,000,000
Cash	1,000,000	1,000,000
Total	$2,000,000	$2,000,000

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If there is no fire, Abdul suffers no loss. Both before and after, his net worth is $2,000,000.

Scenario 2 - Fire destroys house

	Before	After
House	$1,000,000	
Cash	1,000,000	$1,000,000
Total	$2,000,000	$1,000,000

Abdul's house has been destroyed by fire, and he has suffered a loss of $1m. Even if he uses his $1m cash to reinstate his house, his loss is still $1m.

(B) Example 2 - Abdul insures his house with Chowdhury. The premium charged is $1,000 per year.

Instead of being exposed to the risk of loss if his house burns down, Abdul transfers that risk to Chowdhury by paying him $1,000.

Scenario 1 - No Fire

	Before	After
House	$1,000,000	$1,000,000
Cash	1,000,000	999,000
Total	$2,000,000	$1,999,000

If there is no fire, Abdul has suffered a loss of $1,000 being the insurance premium he paid to Chowdhury. Conversely Chowdhury has earned $1,000 by being exposed to the risk of loss on Abdul's house for a year.

Scenario 2 - Fire destroys house

	Before	After
House	$1,000,000	
Cash	1,000,000	$999,000
Cash from insurance claim		1,000,000
Total	$2,000,000	$1,999,000

Abdul has suffered an overall loss of $1,000, which is equal to the amount of his insurance premium. His house, worth $1,000,000 has burned down, but this has been replaced by $1,000,000 from the fire insurance claim since Chowdhury has to pay him the full value of the house since it has been destroyed. The cash from the insurance claim may be used to reinstate his house, but either way his loss remains $1,000. Abdul has achieved a complete risk transfer to Chowdhury under the insurance contract. For simplicity, Abdul's other losses from a house fire such as the loss of irreplaceable personal possessions are ignored. Instead, the analysis just looks at his financial position.

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Chowdury has suffered a very big loss of $999,000 since he took in $1,000 from Abdul as an insurance premium, but had to pay out $1,000,000 when Abdul's house burned down. This shows that writing insurance contracts is an inherently risky business. The buyer of insurance reduces his risk; that risk has to go somewhere, and it goes to the insurer.

(C) Example 3 - Abdul and Bilal enter into a takaful arrangement with each other.

Many definitions of "takaful" are offered in Islamic finance sources, often using concepts such as" the charitable collective pooling of funds for mutual assistance."

However, as explained below, the process is not charitable, since charity means giving something with no prospect of direct benefit to oneself. Instead the arrangements involve an agreement to share risks on a mutual basis, with the initial payment of cash into a common pool which can be used to meet losses. As the contributor's own loss will be covered if it occurs, the process does not involve charity. Indeed, the contributor would not take part if his risks were not going to be covered, and he will assess the financial viability of participation by considering what his risks are, the likelihood of those risks materialising, and the costs of participation.

As illustrated above, the starting position is as follows.

	Initial Position	
	Abdul	Bilal
House	$1,000,000	$100,000
Cash	1,000,000	100,000

The takaful arrangement between Abdul and Bilal is intended to share between them the risk of their houses burning down. Abdul and Bilal agree to contribute to a common pool (the takaful pool) pro-rata to the value of their houses, and to share any pool surpluses pro-rata to their contributions. To ensure there is enough cash in the pool to cover all possible losses, they put in cash equal to the total value of both houses. This is unrealistically high and would not be met in real life. However, it makes the analysis much easier to follow, and does not change any of the principles involved.

As there are only two of them involved, Abdul and Bilal don't need a third party administrator. Between them they will ensure safe custody and investment of the cash in their common pool, and deal with the use of the money in the pool to pay their fire losses, and they will return any excess left over in the pool back to themselves when the takaful arrangement finishes. For simplicity I assume that the invested money does not earn anything, so the cash in the takaful pool is the same at the end of the year as at the beginning.

Scenario 1 – No Fire

	Before		During Year		After	
	Abdul	Bilal	Abdul	Bilal	Abdul	Bilal
House	$1,000,000	$100,000	$1,000,000	$100,000	$1,000,000	$100,000
Personal cash	1,000,000	100,000	-	-	1,000,000	100,000
Total	$2,000,000	$200,000	$1,000,000	$100,000	$1,000,000	$100,000
Cash in takaful pool			$1,100,000	-		

None of the cash in the takaful pool is needed for any purpose. At the end of the year, the cash in the takaful pool is returned to Abdul and Bilal in a 10:1 ratio, being the ratio in which they contributed it. Although they did share their risks during the year, it cannot be seen from the figures as no house burnt down.

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Fire – Variant 1: Assume that both houses burn down

	Before		During Year		After	
	Abdul	Bilal	Abdul	Bilal	Abdul	Bilal
House	$1,000,000	$100,000	$1,000,000	$100,000		
Personal cash	1,000,000	100,000	-	-	$1,000,000	$100,000
Total	$2,000,000	$200,000	$1,000,000	$100,000	$1,000,000	$100,000
Cash in takaful pool			$1,100,000			

All $1,100,000 of cash in the takaful pool is used to pay fire losses suffered by Abdul and Bilal of $1,000,000 and $100,000 respectively. They can use this cash to reinstate their houses if they wish. There is no cash left in the takaful pool. Abdul and Bilal have suffered losses of $1,000,000 and $100,000 respectively from the destruction of their houses.

The losses have been borne in the ratios Abdul 10/11 and Bilal 1/11 being the 10:1 ratio of their house values and takaful contributions. However, any risk sharing is still invisible as both houses burnt down, and Abdul and Bilal are in the same positions they would have been in with no takaful but assuming both houses burnt down.

Fire – Variant 2: Assume that only Abdul's house burns down

	Before		During Year		After	
	Abdul	Bilal	Abdul	Bilal	Abdul	Bilal
House	$1,000,000	$100,000	$1,000,000	$100,000	-	$100,000
Personal cash	1,000,000	100,000	-	-	$1,091,000	9,000
Total	$2,000,000	$200,000	$1,000,000	$100,000	$1,091,000	$109,000
Cash in takaful pool			$1,100,000			

Of the cash in the takaful pool, $1,000,000 is paid to Abdul to compensate him for the loss of his house. The surplus of $100,000 is shared between Abdul and Bilal in a 10:1 ratio, being the ratio of their contributions. Abdul receives $91,000 and Bilal receives $9,000. Abdul and Bilal started with a combined net worth of $2,200,000 which has fallen by $1,000,000 to $1,200,000. The loss of $1,000,000 has arisen from Abdul's house burning down. This loss has been shared Abdul $909,000, Bilal $91,000 i.e. Abdul 10/11 and Bilal 1/11 being the 10:1 ratio of their house values and takaful contributions.

Fire – Variant 3: Assume instead that only Bilal's house burns down

	Before		During Year		After	
	Abdul	Bilal	Abdul	Bilal	Abdul	Bilal
House	$1,000,000	$100,000	$1,000,000	$100,000	$1,000,000	-
Personal cash	1,000,000	100,000	-	-	909,000	$191,000
Total	$2,000,000	$200,000	$1,000,000	$100,000	$1,909,000	$191,000
Cash in takaful pool			$1,100,000			

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Of the cash in the takaful pool, $100,000 is paid to Bilal to compensate him for the loss of his house. The surplus of $1,000,000 is shared between Abdul and Bilal in a 10:1 ratio. Abdul receives $909,000 and Bilal $91,000.

Abdul and Bilal started with a combined net worth of $2,200,000 which has fallen by $100,000 to $2,100,000. The loss of $100,000 has arisen from Bilal's house burning down. This loss has been shared Abdul $91,000, Bilal $9,000 i.e. Abdul 10/11 and Bilal 1/11 being the 10:1 ratio of their house values and takaful contributions.

(D) Conclusions and comments

This is a very simplified example. Nevertheless, some key points emerge.

Conventional insurance risk transfer

Under the conventional insurance contract, there is a complete transfer of fire risk from Abdul to the insurer Chowdhury.

In the long run, Chowdhury will make or lose money, depending on the level of premiums he charges and the actual experience of fire losses. Chowdhury's motivation is to charge the highest premium customers will bear, but this is constrained by competition from other insurers. Chowdhury needs expertise in assessing the probability of house fires. Competitive pressures from other insurers may drive down premium rates and if premiums fall so low that Chowdhury expects to lose money taking into account the probability of houses fires then Chowdhury would be better off ceasing to write any insurance contracts. Having achieved complete fire risk transfer to Chowdhury, Abdul is theoretically indifferent whether his house burns down. He may therefore take less care to prevent house fires, e.g. by switching off electrical items at night. This is one example of the concept of "moral hazard" in economics, whereby a party to a contract starts to behave in an improper way because the terms of the contract mean that the cost of the inappropriate behaviour falls on the other party. In practice of course even with the insurance contract Abdul retains a significant element of fire risk, both to his personal safety and because a fire will destroy treasured personal memorabilia which are irreplaceable.

Risk sharing in takaful

Whereas conventional insurance transfers risk from the customer to the insurer, (for a price equal to the premium), the takaful arrangement socialises risk by sharing it between the participants. In our example, Abdul moves from carrying a 100% risk of his own house burning down to carrying 91% (10/11) of the risk of either house burning down. On both houses, Abdul and Bilal would of course prefer to have no losses, but a fire at Abdul's will cost both of them more money as it is the more valuable house. However note that Bilal's loss of $91,000 if Abdul's house burns down equals Bilal's saving (compared with no takaful) if his own house burns down. If the probabilities of the two houses catching fire are equal, this is a fair relationship for Bilal, and therefore also for Abdul. Expanding the number of pool participants will socialise the risk further.

House fires are infrequent events, but "lumpy" in that a fire represents a big cost to the person who suffers it. Adding more pool participants with uncorrelated fire risks (i.e. the participants should not have houses next to each other) will eventually result in a situation where Abdul has a low percentage of the risk of any house in the pool burning down. Instead of a lumpy exposure (either no loss or large loss) he will most probably suffer a small share of fire losses every year. With a large enough number of uncorrelated risks in the takaful pool, Abduls expected annual loss will be roughly equivalent to the conventional insurance premium currently being charged by Chowdhury, since we have assumed that the premium is based upon an actuarially fair assessment of the risk.

Setting the level of takaful contributions

In our two person situation, each of Abdul and Bilal need to be confident that there is enough money in the takaful pool to cover the cost of reinstating their house in the event of it burning down. As house fires are rare, in most years neither Abdul nor Bilal would experience a fire so the entire pool would be returned to them. Of course this level of takaful contribution is unrealistic in practice. Few people could afford to make a takaful contribution in cash equal to the value of their house, albeit in the expectation of most probably receiving all or most of it back at the end of the year. With a large number of pool members, the annual contribution that

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each of them makes becomes a much smaller fraction of the value of their house. The level should be set high enough to cover expected fire losses plus a safety margin; the precise amount of the safety margin is relatively unimportant since at the end of the year the surplus cash in the takaful pool is returned to the participants. Of course, once pool participants are contributing to the pool less than the full value of every house, there will be insufficient money in the pool to cover the simultaneous destruction of all the houses. However, this is no different from conventional insurance, where no normal insurance company could remain solvent if all of the risks that it had insured materialised simultaneously.

Allocating the takaful surplus

One arithmetical question regarding the allocation of the surplus is whether a participant should share in the surplus if during the year in question he has already claimed on the pool for an actual fire loss suffered. From the examples, if Abdul could not share in the surplus in the version where his house burnt down, his loss would become $1,000,000 while Bilal's loss would become zero i.e. Abdul would have a 100% exposure to the loss of his house while Bilal would have no exposure to a loss on Abdul's house. Accordingly, in this example it is essential that a pool participant is not debarred from sharing in the surplus merely because he has suffered a fire loss, in order to achieve proper risk sharing. With a large number of participants whose contributions are a much lower proportion of their house values, the surplus sharing question becomes less acute. If the contributions are set carefully enough each year the cash in the pool should just cover the total fire losses experienced, with no surplus or deficit. While this ideal scenario is somewhat unlikely, in practice the pool surplus or deficit should be quite small compared with the aggregate value of the houses at risk so the risks are socialised irrespective of the precise method used for allocating the pool surplus amongst participants.

Are the contributions fair to the participants?

Abdul and Bilal have houses with dramatically different values. However in the example they are able to pool their risks in a manner which leaves both Abdul and Bilal sharing proportionately in the fire risk of both houses. This seems fair. However, it would not be fair if one house was more likely to catch fire than the other. For example, if Abdul's house is made of stone, with an expectation of getting burnt down once every hundred years, while Bilal's house is made of wood with the expectation of burning down once every decade, then Bilal's house is ten times as risky as Abdul's. This needs to be factored into the risk sharing arrangements. The conventional insurer Chowdhury will simply allow for the relative probabilities when quoting insurance premiums to Abdul and Bilal. He would quote a premium of $1,000 to Abdul (being 0.1% * $1,000,000) while also quoting a premium of $1,000 to Bilal (calculated as 10 * 0.1% * $100,000 since Bilal's house is ten times as risky.) Accordingly, when operating the takaful pool, Abdul and Bilal need to allow for these risk probabilities (assuming they can estimate them) when devising the arrangements. For example, Bilal and Abdul might agree that Bilal's share of the pool surplus will be 9/10 of what it would otherwise be, to reflect the riskiness of his house. Accordingly, in years when no fire losses were experienced, the arithmetic would be as follows:

	Abdul	Bilal	Total
Pool contribution	$1,000,000	$100,000	$1,100,000
Fire losses	-	-	-
Pool surplus to allocate			1,100,000
Initial allocation based on contribution	1,000,000	100,000	1,100,000
Reduce Bilal's surplus to 9/10	10,000	(10,000)	-
Final share of pool surplus	$1,010,000	$90,000	$1,100,000

Over a decade, this arrangement will cost Bilal $100,000 being the value of his house. This cost matches the expected total loss of once per decade that Bilal expects. In the year of loss, the outcome will be:

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	Abdul	Bilal	Total
Pool contribution	$1,000,000	$100,000	$1,100,000
Fire loss (Bilal's house)	-	(100,000)	(100,000)
Pool surplus to allocate			$1,000,000
Initial allocation based on contribution	$909,000	$91,000	$1,000,000
Reduce Bilal's surplus to 9/10	9,000	(9,000)	-
Final share of pool surplus	$918,000	$82,000	$1,000,000

The overall outcome appears slightly unfair to Bilal, since as well as suffering the cost of $10,000 per year in the years when there is no fire, he also suffers a similar cost in the year of loss. It shows how hard it is to be fair in all circumstances. Accordingly it would seem more appropriate to not scale down Bilal's share of any pool surplus to 9/10 in the year when he actually suffers the house fire.

Takaful in practice

The extremely simplified examples above enable one to think about some of the issues that arise when devising real takaful arrangements.

In practice however takaful arrangements for retail risks are not devised by the parties seeking to socialise their risks, they are devised by takaful operators seeking to sell their expertise to potential pool participants.

Some of the factors the takaful operator needs to take into account are:

• Pool participants will want to share the risks of their houses starting from random dates in the year (e.g. the date they purchase the house) so that the simple example of assessing the pool on an annual basis with all outcomes known is not possible. Instead, the pool operator will need to allocate the participant contributions between accounting years to calculate the surplus for each year.

• Pool participants will primarily see their contribution to the takaful pool as a cost, reduced perhaps by any small share in pool surplus. Furthermore, they will compare this cost with the price of conventional insurance. In economic terms it makes little difference to a pool participant whether he is socialising risk with a large number of pool participants or paying a conventional insurer to take on the risk. (Of course the two may be seen as completely different from a religious perspective).

• A conventional insurer bears all of the losses experienced, in exchange for the premiums it receives. Accordingly, it is incentivised to quote premiums that at least cover the expected losses in respect of each customer. The more scientifically the insurer can assess the riskiness of each customer, the more profitable it will be, as it can decline more risky business or quote higher premiums.

• A takaful operator is reimbursed by a fee, and does not share in actuarial gains or losses. Typically the operator will make an interest free loan to cover pool deficits, repayable out of pool surpluses. Otherwise, pool surpluses are all returned to pool participants. Accordingly, the takaful operator has an incentive to avoid pool losses, but limited incentive to screen out bad risks, since the losses arising from these bad risks are borne by the other pool participants, not by the operator.

• There is however some incentive to screen out bad risks or to charge them a higher contribution, since customers will decide to join a particular operator's pool based upon the experience of contribution rates and pool surpluses. As bad risks cause increased contributions/reduced surpluses, the operator's business is likely to expand if he can exclude them. However this incentive is less strong than with conventional insurance where the insurer bears all losses directly.

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Featured Structure

Conventional insurance and takaful compared

Most Muslim scholars consider that conventional insurance is prohibited in Islam, except where required by local law (such as compulsory driving insurance in the UK) while there is no Shariah compliant alternative. The scholars point towards two factors:

i. The conventional insurance contract with its risk transfer from the customer to the insurer is inherently prohibited. The most important reason given is that the contract is speculative, like gambling, as either the insurer will have a small gain from keeping the premium or a large loss from paying out on the claim.

ii. Conventional insurers invest their premium income (pending payment of claims) in prohibited ways, by purchasing interest bearing investments (regarded as prohibited) and equity investments in prohibited businesses such as alcohol production.

The above two reasons are logically distinct. While a conventional insurer could remedy reason (ii) by changing its investment policy, it could not remedy reason (i) while continuing to write risk transfer contracts.

In comparison, takaful is generally approved from a Shariah perspective on the grounds that the parties at risk are effectively indemnifying each other through the takaful risk sharing mechanism. The takaful provider is merely providing a service for a fee charged to participants (normally via charging the pool) but is not taking on the customers risks which they share with each other.

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Ibra': Should it be Discretionary?

By Marjan Muhammad and Hakimah Yaacob

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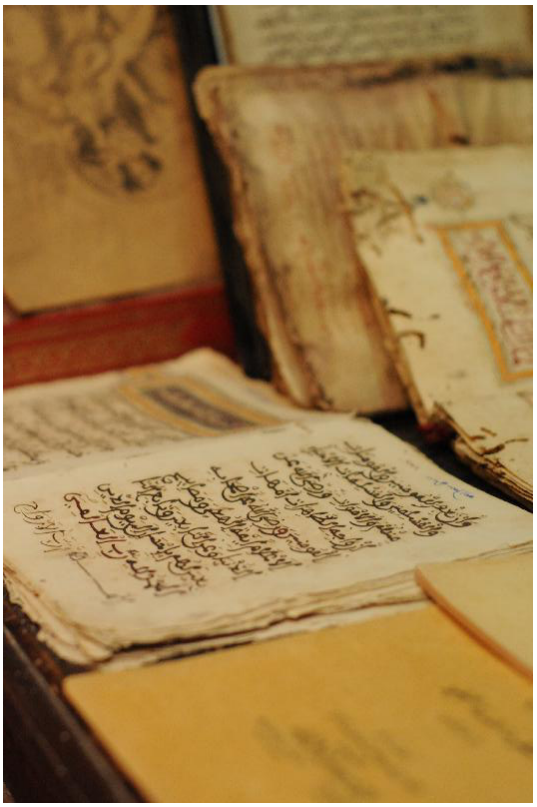
Hakimah Yaacob is an Associate Researcher at the Islamic Banking Unit, International Shari'ah Research Academy (ISRA) for Islamic Finance.She holds a Bachelor of Laws (Hons), Bachelor of Syariah (Hons), a Master in Comparative Laws, from International Islamic University Malaysia and a diploma from Tokiwa International Institute, Japan. Previous positions held include Head of Law Reform & International Treaties, SUHAKAM, legal practitioner, as well as being the Drafter of International Standard Organisation 26000 on social responsibility. She has published many articles on alternative dispute resolution (ADR) in Islamic finance including arbitration, mediation and hybrid ADR



The concept of ibra' in Islamic laws has normally been discussed and applied in issues regarding debts (duyun) and rights (huquq). Literally, the word ibra' is derived from the Arabic root word of bara'a which means removal and acquittal from something. According to Ibn Al-A'rabi, bara'a connotes several meanings, i.e., to free, to purify, to avoid and to remind. Technically, ibra' is defined as either "considering one's debt as a gift to him", or "absolving the ownership that is in one's liability". In the context of Islamic banking and finance, ibra' generally refers to giving ownership or absolving one's right of the debts that are in the other's liability in partial or total.

In certain legal documentations in Islamic finance, it is a practice to include ibra' clause in the sale contracts involving the element of debt such as Bay' Bithaman Ajil (BBA), Murabahah, Bay' al-Inah and Bay' al-Tawarruq. In Malaysia for instance, almost 80% of Islamic banks apply ibra' clause whether it is expressly or impliedly stipulated in the contract. The bank at its absolute discretion, as a party who has rights on the debt, will grant ibra' for a prepayment (early settlement) or on a termination of the contract due to breach and default. Nevertheless, the application of ibra' has recently caused disputes in courts. Almost 90% of registered mu'amalah cases at the High Court

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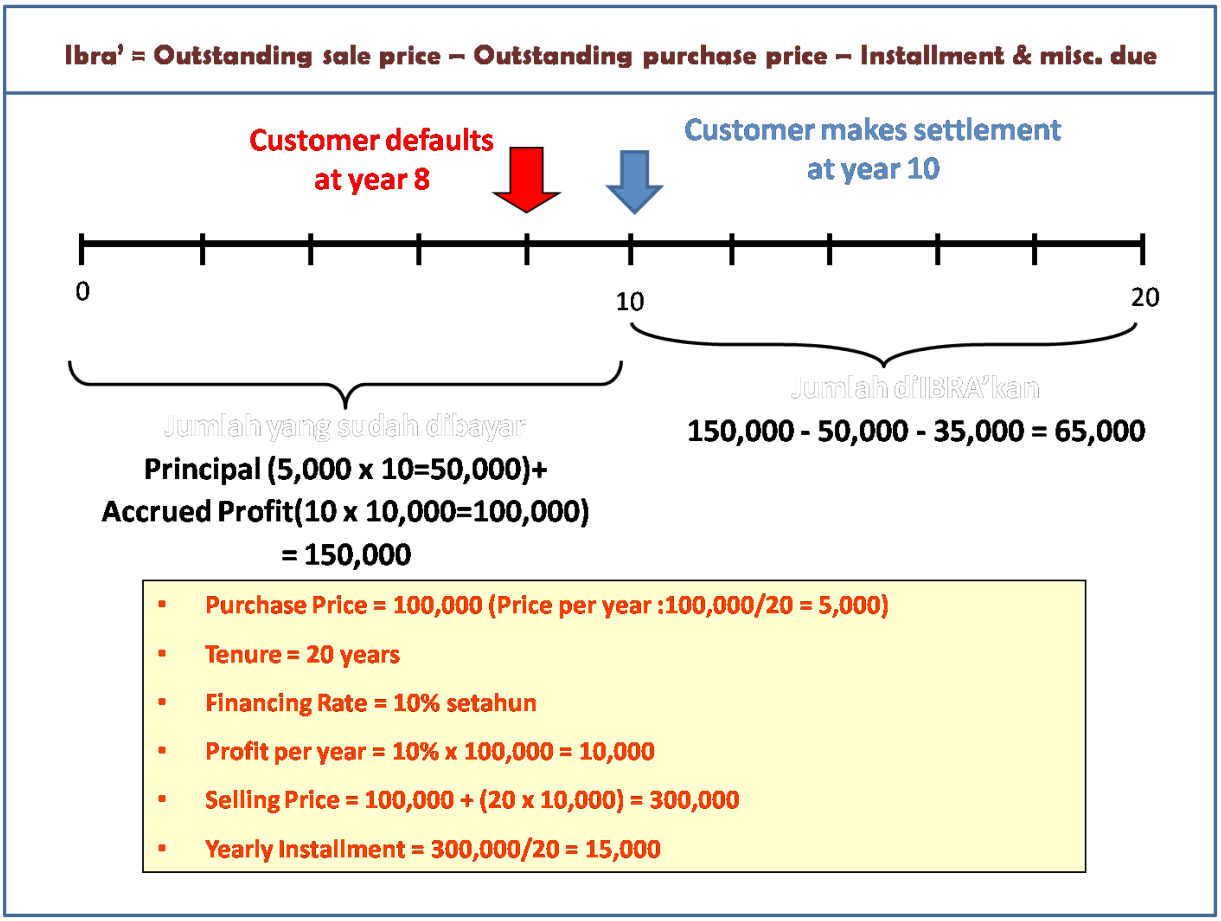
of Kuala Lumpur from 2003-2009 are related to both retail and corporate products of BBA, in which the disputes revolve around the quantum of bank's claim when BBA contracts are terminated due to the defaulted customers.

Hence, this article will shed light on the status of ibra', whether to remain as a discretionary or to shift to an obligatory. Based on the analysis made on the above mentioned cases, the main argument is relating to the ibra' calculation[1] as its formula is not transparently disclosed by the banks in the contract. From 2003-2004, the words ibra' or unearned profits is not mentioned in any of the files. It was only in 2005, the court started to order 'deduction of unearned profits' from the judgment sum. There was 1264 out of 2245 court orders in 2005-2009 contain the word 'deduction of unearned profits'. The court order reads: "judgment sum granted with unearned profits to be deducted upon full settlement on the settlement day". Starting from 2008, the court started to use the words ibra' and 'deduction of unearned profits' interchangeably.

Polemics on this issue arise when the bank considers granting ibra' as a discretionary (tabarru') in nature, whereas the customer assumes that ibra' will automatically be given when any prepayment is made or the contract is terminated. In the case where the bank refuses to grant ibra' in a default payment, therefore the customer needs to pay the full amount of total selling price less the paid amount.

In reaction to this, the Shariah Advisory Committee of Bank Negara Malaysia in several meetings resolved that the ibra' clause should be incorporated in the contract agreement. The justification for the incorporation is to uphold the fairness and justice between both contracting parties. As the clause is discretionary in nature, therefore, it is still not binding the bank to grant ibra' to the customers in both prepayment and contract termination cases. Exhibit 1 depicts an example of how ibra' is calculated based on the formula employed by Islamic banks. This formula is however not spelt out in the contract.

Exhibit 1: An Example of Ibra' Formula and Calculation



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What is a Discretionary Clause?

It refers to the clause that gives discretion to the authority (banks) to determine the eligibility for benefits, to calculate the payment or to interpret the terms or provisions of the policy or contract. In the United States of America, the Texas Department of Insurance has filed a proposed rule that would prohibit the use of discretionary clauses in life, accident, and health insurance policy forms. The proposed rule was filed as a result of an October 2009 request from the Office of Public Insurance Counsel[2]. According to them, discretionary clauses are contractual provisions that reserve or purport to reserve for insurers the discretion to interpret the terms of an insurance contract. The main reason of introducing the new rule was to protect insurance consumers from the possibility of incorrect and unfair coverage determinations by insurers without a subsequent opportunity for a full and independent review under a non-deferential standard.

Therefore, ibra' clause can make those payments contingent on the unfettered discretion of the bankers. It will thereby nullify the promise to pay and render the contract to potentially illusory due to its "discretionary" in nature. This may also lead to riba and gharar which are the main prohibitions in Islamic finance.

Regardless of whether ibra' is regarded as hibah and unilateral in nature, based on maslahah and to avoid exploitation from the banks upon the calculation of ibra', the regulator should make it compulsory rather than discretionary. According to a hadith, the Prophet used to prohibit his companions from eating and keeping the meat of sacrificial animals (luhum al-adahi) at home for more than three days, and oblige them to give it as a charity to the group of nomad people who came to Medina at that time. When the reason de'tre (i.e. the presence of the nomad people) disappeared, the Prophet had allowed the companions to eat and keep the meat as they wished.

Although the act of giving charity is originally regarded as optional and praiseworthy, the Prophet had made it compulsory due to the circumstances appeared at that time. This is an illustration of a situation which is praiseworthy in nature can change to obligatory due to the need of the society. In conclusion, should we maintain the practice of giving ibra' as discretionary or should the discretionary clause be banned and make it compulsory? To maintain it as discretionary, and to apply it as our 'urf tijari, it will bring hazard and uncertainty to the practice since most of the cases disputed in the court are related to the ibra' calculation. On the other hand, to make it compulsory, the regulator must come out with its own calculation and applies to all banks, or alternatively the banks can come out with their own matrix which is approved by the regulator.

References:

1 Analysis of Muamalat cases at the High Court of Malaysia from February to April 2010.
2 http://www.insurancejournal.com/news/southcentral/2010/05/26/110211.htm#ixzz0pZugQzPU
(Shari'ah) validity, then the above cases provide strong indications of the potential results. Should this continue, the industry will be presented with a serious legal dilemma in the future.

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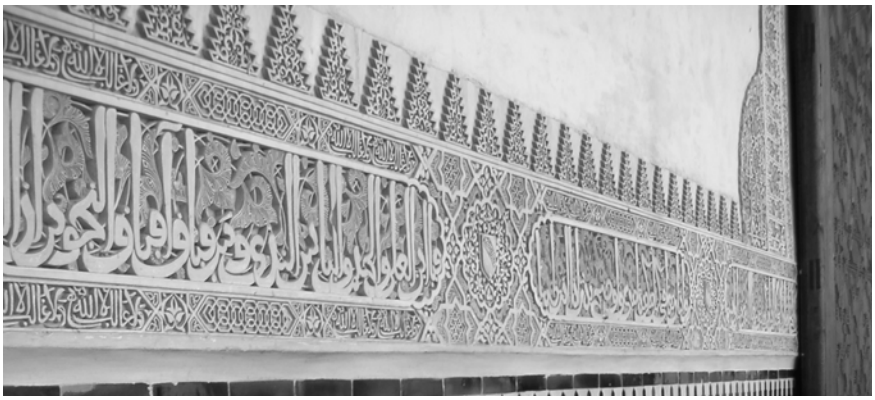
A study of Islamic Finance: My search for a new path

By Mobasher Zein Kazmi

The writer completed his MBA (Investment Management) from Concordia University and is a CFA Level 3 candidate. He was recently awarded the Islamic Finance Qualification (IFQ) designation. Mobasher has had four articles published in the Journal of Strategic Studies, Bahrain Center for Studies and Research. The first three dealt exclusively with Islamic finance topics namely: Sukuk (see reference link), Islamic Hedge Funds (see reference link) and the impact of the current financial crisis on Islamic banks (see reference link). The last paper dealt with the rise of sovereign wealth funds.



My entry into the research of Islamic finance topics began rather innocuously. The Islamic International Rating Agency (IIRA) where I was interning had received a request from a financial journal based in India seeking information on Islamic bonds (Sukuk). At the time they were the flavor of the month for issuers seeking to diversify their sources of funding and serious investors were somehow intrigued by the risk-adjusted return potential of a new class of alternative investments. I was asked by my superiors to prepare specific responses to their queries and as my investigation of sukuk began I unlocked a mysterious world that had been absent from my MBA classes at Concordia University in Montreal, Canada and from the CFA curriculum.

It was the first time I had come across terms such as Sukuk-Ijara or Musharakah not to mention the various other sukuk structures. The names sounded quite intimidating at first and I decided to print a small booklet of Islamic finance definitions to keep handy for quick consultations. The challenge was not only in understanding the product but in addressing the fundamental source of concern for any investor: risk. The wealth of information available online and within the agency needed to be collated and aggregated properly so as to provide a measured response. After an exhaustive period of fact-checking on sukuk issuance numbers and prospects for market growth I had prepared a decent first draft; worthy I felt of onward distribution.

This paper included an analysis of the various risks borne by a sukuk investor, namely:

i) Rate of return risk (Interest rate risk)
ii) Credit risk
iii) Foreign exchange rate risk

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iv) Price/Collateral risk
v) Liquidity risk
vi) Sharia'a compliance risk

This entire experience forced me to consider expanding my research and provide readers with a broader and more meaningful understanding of a concept that remained a mystery to people outside the inner circle of Islamic finance. Prior to my departure to Canada I was fortunate to be introduced to the Editor of the Strategic Studies Journal, Bahrain Centre for Studies & Research who was searching for scholarly work on Islamic finance topics for publication. I promised him a research piece on Islamic bonds and after receiving the necessary approval continued to produce Islamic finance articles for the Strategic Studies Journal whilst completing my graduate studies.

Fortunately the editor had allowed me the freedom to choose my own research topics from where I delved in to Islamic hedge funds and the impact of the global financial crisis on Islamic financial institutions. A related paper on Sovereign Wealth Funds was also prepared given the prevailing interest at the time in the concept of geo-economics. Indeed all the topics I had researched had already received considerable coverage by the financial press enabling me to quickly piece through information and identify the most relevant and critical factors necessary for my analysis.

Moving forward it is likely I will be paying a great deal of attention to Islamic Equity Funds. I would like to delve in to performance attribution and evaluation of the top performing Sharia compliant funds. Indeed I hope to see myself managing my own Islamic fund one day and understanding the whys and how of the Islamic investment processes should certainly be another integral step in reaching that destination.

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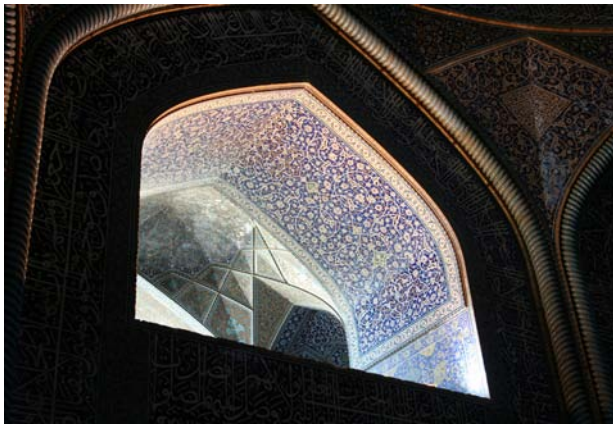
The Islamic Window: Young but Disconnected

By Joy Abdullah

Joy Abdullah, Brand Strategist, has more than 20 years of experience across ASEAN & the Indian sub-continent in developing and managing national, regional and international brands in a wide variety of industries covering Islamic Financial services, tourism, B2b Halal, telecommunications, beverages, real estate, tobacco, hospitality and healthcare.



A recent article published in Marketing Week (see reference link) highlighted that "Muslim consumers are a growing, influential and extremely loyal group, making them a desirable market for mainstream brands. But reaching them requires more than launching Sharia-compliant products. Making inroads to this sector takes deep understanding of the values of this community and building the brand from there. They're young, ambitious and worth at least $2 trillion globally". This however seems to suggest there is something missing from Islamic finance offerings.

There are two key points that need to be scrutinized further:

1 Understanding the implication of the "values" of Islam
2 Reflecting these values throughout the business model (for an organisation)

For the Islamic finance industry - and in particular the retail segment within it - the question to answer is "how ethical an entire banking brand is". It seems this is the question that needs to be posed to the growing segment of the global Muslim youth. These upcoming consumers want to know (or be reassured) that the financial institution is being run ethically and sustainably. Demographically this is an energetic consumer group, but it is a discerning one as well. They are far less convinced by an Islamic banking 'window' from a brandname-bank (that runs the bulk of its business on conventional finance elsewhere in the world) or with hefty usage of "Shariah compliant" words on the product documentation. They seem to be wanting something more (or perhaps something else altogether).

The partial answer to this is not just through mass-media communication or through Shariah compliant labeling but through "actions". Concerted actions such as:

A. Brand Reputation—a planned strategic reputation management plan should be in place in order to generate "trust" with the consumer. Such a plan would encompass all stakeholders of the (concerned) brand and provide them "information/knowledge" of how Islamic values actually make up the brand's work culture and philosophy and is of benefit to them.

B. Financial management education—for the consumer & the organisation's staff who interact with all the stakeholders (of the concerned brand). This education, primarily, would have to communicate the intrinsic "benefit" of an Islamic Financial product, again, stemming from the values of the brand. And thereby, re-position the entire competitive framework of evaluating an Islamic Financial product vs a conventional financial product.

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C. Creating perception: By actively delivering on the values claimed on a daily basis through interaction.

D. Learning through listening: And being in the learning mode by listening to what the stakeholders are saying/asking with regards to their needs and involving them in the brand's development process.

Understanding Islamic values and utilising it in developing a strong brand identity, the growing pride of being a Muslim amongst the young and taking into account their social clout in terms of global connectivity through social media, are key in developing strong relationships with the global Muslim youth who would be the future life-time customers of the Islamic financial industry (see reference link).

Showing a strong understanding of Islamic values at a non-superficial level is vital for any brand that wishes to target Muslim consumers. Displaying this understanding instead of pushing the brand's own values would aid tremendously in creating brand preference and a base for a strong customer relationship.

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Zaid Ibrahim Report on Islamic Finance

By Blake Goud

Blake Goud is the principal of Sharing Risk dot Org (see reference link), he is an expert researcher on Islamic finance as well as a freelance journalist with a monthly column in Business Islamica magazine and the US correspondent for Islamic Business & Finance magazine. His areas of focus within Islamic finance are its growth within non-Muslim-majority countries, microfinance and the interaction of Islamic finance with other forms of ethical finance. He currently serves as Chief Compliance Officer of Marquam Capital, an investment advisory firm specializing in ethical investing.

The Malaysian law firm Zaid Ibrahim & Company recently released a report (see reference link) entitled "Demystifying Islamic Finance" which reviews 14 misconceptions about Islamic finance as well as 10 value propositions. For people familiar with Islamic finance, the report does not provide anything new or controversial. However, it is a useful resource for anyone interested in promoting Islamic finance in regions where it is not common or well understood. For this it should be commended because there are no other resources that present similar information in such a compact and readable format.

Several of the misconceptions (for example that Islamic finance is terrorist financing, it is for Muslims only and that it is welfare finance) are commonly enough understood as false that they need no detailed explanation. However, there are several that deserve a brief overview. The report clarifies the debate about standardization in Islamic finance by pointing out the wide areas where there is standardization. For example, many Islamic banks' products are nearly identical globally. The contentious areas of standardization remain under debate but many aspects of Islamic finance are standardized, for example accounting and auditing standards developed by AAOIFI.

Another area where the report provides a good overview is dealing with the idea that Islamic finance is intrinsically superior to the conventional financial industry; that it is less risky, has lower costs of funds and is immune from crisis and unethical dealings. Islamic finance may strive to be more ethically-driven than the conventional financial industry, but that depends on individuals' behavior. There is no guarantee that Islamic finance practitioners will behave in a more ethical way. A recent article from July 2, 2010 in Reuters described the difficulty of Islamic finance growing in Egypt in part because there were many frauds in the 1980s by investment companies that labelled themselves as 'Islamic'.

Just as Islamic finance depends on ethical behavior by its practitioners, it is also subject to excessive risk taking and the bubble mentality which recently drew financial institutions, both conventional and Islamic, into an unsustainable finance bubble that popped following the global financial crisis. The Islamic finance industry may avoid the most leveraged areas that fell furthest in the financial crisis, collateralized mortgage obligations (CMOs), credit default swaps (CDS) and the rest of the alphabet soup of highly leveraged products.

Even institutions that minimized their participation in overvalued property markets in some parts of the GCC were hurt in the financial crisis because of their linkage with the real economy. Once the financial crisis (where they saw liquidity dry up) abated, the economic recession reduced the value of many investments outside of the bubble areas and this has affected the Islamic financial industry and caused substantial losses and reduction in profits of these institutions.

15 Most Frequent Misconceptions of Islamic Finance

1. Terrorism Finance
2. For Muslims Only
3. Replica of Conventional Finance

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4. Primitive Methods of Doing Finance
5. No Standardisation of Best Practices
6. More/(Less) Risky than Conventional Finance
7. Lower/Higher Cost of Funds
8. 'Welfare' Finance
9. No Guarantee
10. Driven Purely by Oil Boom
11. Immune from Any Unethical Practice
12. Immune from the Global Financial Crisis
13. Governed only by Shariah
14. Requires Minimal Changes to legal & Regulatory Framework
15. To Replace Conventional System, aimed towards Islam's world domination

Source: Zaid Ibrahim & Co report (see reference link)

In the second section of the report, Madzlan Hussain, the author and a lawyer at Zaid Ibrahim, describes the value propositions that Islamic finance creates compared with conventional finance. In contrast to the description and refutation of misconceptions, I found some of the value propositions lacking. There were some—promoting cross border trade and flows of funds and financial inclusion of an underserved segment of the community, closer support to the real economy—that are clear. However, other value propositions are less certain.

For example, the report says that there is more diversification of risk in Islamic finance. In part, this section describes the development within Islamic finance to create more avenues for diversification; the industry still lacks well developed, deep secondary markets for fixed income outside of Malaysia. This ties in with another value proposition of Islamic finance as a new asset class. Islamic finance may become a new asset class where risks and rewards are shared in a different method compared with conventional finance. However, today most Islamic financial products are designed to largely replicate a conventional product: sukuk replicate the risk/reward structure of conventional bonds, the Tahawwut Master Agreement for Shari'ah-compliant derivatives tries to create an Islamic alternative to the ISDA Master Agreement for conventional derivatives.

Another value proposition is that Islamic finance provides greater systemic stability than conventional finance. Just as derivatives were thought to spread risk across the system to reduce instability, the risk-sharing principles in Islamic finance may not function exactly as envisioned in a future crisis. Islamic banks and other financial institutions are still vulnerable to runs by depositors and drying up of liquidity. The systemic risks, which were described in detail in a Islamic Financial Standards Board-Islamic Development Bank-Islamic Research & Training Institute report may be more acute because there is not well developed Shari'ah-compliant deposit insurance or interbank money markets.

10 Main Value Propositions of Islamic Finance

1. Adherence to Shariah, Subscribing to Higher Ethical Ideals
2. Promoting Crossborder Trade and Flow of Funds
3. Financial Inclusions of the Underserved Segments of the Community
4. Expansion of a New Asset Class
5. More Diversification of Risks
6. Unlocking the Values of Idle Assets
7. Job Creation
8. Sound Risk Management
9. Closer Support to Real economy
10. Systemic Stability

Source: Zaid Ibrahim & Co report (see reference link)

The level of depth of these criticisms are outside of the scope of the Zaid Ibrahim report, which was aimed at people unfamiliar with Islamic finance. It is also much easier to correct misconceptions than it is to describe in brief constructive value propositions that Islamic finance can provide. As such, the report is a valuable starting point and will hopefully create greater awareness of Islamic finance, reduce misunderstanding of how Islamic finance works and what it can and cannot provide, and lead to further discussion of the value proposition of Islamic finance.

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Alignment Of Corporate Governance And Company Performance: A Focus On Takaful

By Omar Clark Fisher PhD

Dr. Fisher has extensive industry experience spanning over 15 years, which include leading the investment banking team that launched t'azur company; Managing Director, Takaful Business Development at Unicorn Investment Bank; as well Deputy Head Takaful Division at Bank Al-Jazira. He is a frequent presenter at internationally-recognized trade and insurance industry conferences and is the author of numerous articles on Islamic finance, leasing and Takaful (including three books). Omar holds a PhD Management Philosophy-Takaful, a joint degree conferred by International Islamic University of Malaysia and Camden University.

Corporate Governance and Company Performance

From Board rooms, to regulators' offices, to stock exchange trading floors the global debate marches on: does good corporate governance enhance stock prices and/or shareholder value?

While research studies are by no means conclusive, evidence is mounting up that "better corporate governance leads to better future financial and stock performance"1. According to the Policy Brief published by the Hawkamah Institute, "In its September 2005 report, 'The Irresistible Case for Corporate Governance,' the International Finance Corporation (IFC) asserts that sound corporate governance increases company valuations by 20-30% in developing markets and leads to higher credit ratings and a corresponding improvement in access to finance."2

A Wilshire Report in July 2009 documented statistically the positive impact of good corporate governance on share prices of 139 public companies that the California Public Employees' Retirement System (CalPERS) invested in beginning in 1987 and thereafter insisted they adopt corporate governance policies and best practices. Compared to a benchmark return on cumulative basis, average companies invested into by CalPERS yielded 3% per annum higher, or a 5 year excess return of 15.3%3. Significantly, Wilshire found that institutional investment by CalPERS and the updgrading of corporate governance led within one year to "targeted poorly performing companies to underperform by only 1.5% vs. a massive 23.6% underperformance just one year prior." 4

Another finding of the Hawkamah Institute is that: "Shari'a compliant insurance companies need to explain clearly the relationship between the policyholders' fund and the operating company. In particular, shareholders need to know what their obligations will be to support the policyholders' fund in the event that the fund faces financial difficulties. Disclosure should focus on the legal relationship between the two entities, and also disclose any regulations to which the takaful firm is subject, which may affect the flow of funds between the two entities."

Dr. John Lee, Executive Director, KPMG commented in June 2009 on Exposure Draft No. 8 from International Financial Services Board (IFSB) of Malaysia regarding corporate governance for Takaful companies: "Because of structure of Islamic finance, the need for transparency is even greater than perhaps in conventional. The fact that participants have a direct stake in some of these transactions, I think that's why there's so much emphasis on the need for transparency. So who's looking after the interests of policyholders? Some would argue that perhaps it's the Shari'a board... but a lot of the role of the Shari'a board has been confined to product development

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areas as opposed to looking at broader issues such as fairness to policyholders." Although worldwide there are four variations of the basic system of Takaful, the Islamic alternative to conventional insurance, common elements are apparent. Succinctly put, these are:

- Insureds make contributions (often called "tabar'ru or donations) rather then pay premiums
- Core essence is mutual assistance to needy members of the group (or ta'awun)
- Risk-sharing among members (form of joint indemnification) rather than risk transfer
- Avoidance of prohibited elements such as al maisir (form of gambling), al gharar (uncertainty and deception) and al riba (interest or forbidden types of commercial gain)
- Separation of ownership interests of policyholders (members) from shareholders
- Use of Shari'a compliant agreements in all activities – including investment of contributions and share capital
- Excess funds resulting from annual operations – called Surplus not profits – legally belongs solely to policyholders (who after all contributed the risk capital) and not to shareholders, as is featured by stock insurance companies. Based upon the above, lets examine five (5) observations that arise.

Misalignment of Shareholders' and Policyholders' Interest

With one exception5, the Takaful models employ an organizational structure whereby shareholders assert themselves as "agents" for the policyholders through Mudareb or Wakala arrangements. This arrangement is typically legitimized by the voluntary purchase by the policyholder/member of a Takaful Operator's policy. However, many Takaful policies are frankly oblique in terms and conditions, and may not fully disclose rights, responsibilities and fees attendant to this arrangement. Hence, the first important observation is the rights, responsibilities and role of policyholders are not always clearly set forth and readily disclosed in ads, brochures, web sites, let alone in actual policy wordings. Common practice under good corporate governance requires that customers (read policyholders/members) be provided clear, unambiguous and easily accessible descriptions of rights, responsibilities and other consumer protection disclosures, today circumscribed by normal business practices—especially in financial services. No doubt in reaction to the recent global financial crisis (2007-2009), regulators and insurance practitioners alike are giving more attention to transparency and disclosures.

Secondly, nearly all Takaful Operators establish themselves as managers of the risk pool with no consultation with policyholders—the main beneficiaries of that risk pool. Of the various policies the author has read, not one specifies how policyholders can appoint management or even remove management. It seems their sole recourse is to lapse their policy, or to terminate the policy early if aggrieved or somehow poorly represented by their "agent", the Takaful Operator. Again, good corporate governance practices amongst stock companies generally (including insurance) sets forth the manner in which customers (read policyholders) can complain, influence business management or in extreme cases, mount an appeal to the Board via a proxy campaign or via legal recourse called "class action suit" to impress upon management its grievances.

Thirdly, on a slightly more technical point, the calculation of Surplus at year end is conducted by shareholders only through management with no consultation (again) with policyholders. The decision about retaining Surplus, adding to Reserves or size and timing of Distribution of funds is totally determined by the Takaful Operator. Some industry experts take comfort in the Sharia Supervisory Board's oversight of Takaful business operations, which does include this issue of Surplus calculation. Nonetheless, Surplus is right of policyholders who have contributed that risk capital to the Takaful pool. Good corporate governance should dictate that policyholders be actively involved in such calculation and decision-making, rather than resort to a "watch-dog" status for scholars or discovery through a Shari'a audit, which is still not a regular and respected fixture of Takaful operations globally.

Fourthly, a survey of Takaful companies around the globe will demonstrate that so far the Board of Directors represents solely the shareholder's interests. Many boards do not yet have even independent board members (ISAS recommends 1-3), nor any representatives from policyholders6. Fifth and finally, despite the importance of policyholder capital (in the forms of annual contributions as well as accumulated reserves) in addition to shareholder capital (albeit not at direct risk to claims payments), Takaful companies typically are not involving policyholders in either investment decision-making neither in major decisions such as mergers, acquisitions or divestment of large assets. Again, these decisions significantly influence the financial strength of the Takaful yet occur at the Board level with no consultation or inputs from the Takaful's constituency—the policyholders. By contrast as shown in the descriptive table below, mutual insurers dare not resolve such decisions at the Board level alone, and usually consult policyholders via a referendum, survey or even proxy voting.

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Comparative Roles of Policyholders

Intuitively, people feel safer in a group. Most people will opt for the security, relative safety and economic benefits to themselves at mutual risk-sharing. Indeed, mutual risk sharing in the modern day bears a striking resemblance to the ancient Arab tribal practices. However, upon closer examination there are important differences, as are shown in the table below:

	Cooperative	Mutual	Takaful
Ownership	1. Jointly owned	1. Jointly owned by members yet no individual rights over property	1. Joint indemnification yet no individual rights over property (contribution is tabarru / donation)
Governance	2. Governance by democratic voting	2. Governance one man one vote	2. Governance is arranged by shareholders; typically, no special voting rights of members
Offerings	3. Products for coop members only	3. Products for all; buyer becomes a member	3. Products to all; buyer becomes member
Shareholders	4. No shareholders	4. No shareholders	4. Shareholders for Takaful Operator separate from members of risk pool / fund
Management	5. Management appointed by coop members	5. Management appointed by board of mutual, elected by general assembly of members	5. Management self-appointed by shareholders of Takaful company; structure is consented to by members when buying policy
Investments	6. As per conventional insurance regulations, equities, bonds, real estate, etc.	6. As per conventional insurance regulations, equities, bonds, real estate, etc.	6. As per Takaful regulations, must be sharia compliant and Riba-free
Deficit	7. Members may be assessed to cover deficits	7. Members may be assessed to cover deficits	7. Members may be assessed to cover deficits but typically shareholders of Operator extend benevolent loan (interest free) to cover deficits in risk pool
Liquidation	8. Members will own assets in liquidation	8. Members will own assets in liquidation	8. Assets of risk pool are donated to charity upon liquidation

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Guidance from IAIS and IFBS on Corporate Governance

IAIS guidelines and IFBS recommendations on good corporate governance for Islamic insurance companies may be summarized:

1. Clear roles and responsibilities for

- Board
- Board Committees – remuneration, investment, risk management, audit and perhaps Corp Governance Implementation
- Senior management- job descriptions; Lines of authority; authority matrix
- Shari'a Supervisory Board – how appointed; how removed
- Auditors – both internal and external audit; who conducts a Shari'ah audit
- Policyholders – what are PH rights; obligations; how to terminate a policy; how to lodge a complaint; or appeal a complaints resolution

2. Clear pathway to resolve conflicts and disputes – explain the treatment of complaints

3. Verification of compliance – adhere to U/W guidelines; financial reporting; regulatory; Shari'a; investments compliance

4. Adopt Code of Ethics for business and conduct of personnel – both operations and sales staff; how does the Code extend to 3rd parties like banks, brokers, other intermediaries; how to enforce compliance

Essential Elements in Takaful Corporate Governance

We may conclude, therefore, that essential elements of good corporate governance for a Takaful operations would incorporate the following items:

- Be consistent with Takaful risk sharing model (congruent with Takaful business principles)
- Existence of Ethics Code for business operations and binding on personnel
- A fair balance of Shareholder (SH) interests and Policyholder (PH) interests
- Encourage policyholder representation and, where possible, participation in management decision-making in matters of direct impact to policyholders
- Market discipline imposed through disclosures and financial reporting
- A goal to manage the business to be self-sustaining, fulfilling solvency requirements (in compliance with insurance regulations of that jurisdiction) rather than maximizing profits for only the Shareholders
- Pursue sound investment strategies (matching assets/liabilities, sound liquidity, safety and diversification) in accordance with Shari'a compliant rules

Given the above discussion, the author humbly suggests that an additional core principle be included into the definition of what makes a Takaful:

- Tabar'ru – contributions from members or policyholders are donation
- Ta'awun – mutual assistance extended from the group risk pool
- Prohibition of riba and other impermissible commercial elements– in both Shareholder capital and Policyholder common funds
- Surplus excess funds at year end legally belongs solely to Policyholders
- (added) "Voice" and participation by Policyholders in Takaful operations

Moving Forward - The Major Challenges

As Takaful companies enter only their 4th decade of existence, as contrasted with conventional insurers whose longevity exceeds 400 years, one may assert that formidable challenges lie ahead in execution of good corporate governance; namely:

1. Balancing the conflicting responsibilities and interests of Shareholders/Policyholders within the hybrid Takaful model as to:

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- Capital adequacy
- Risk management
- Transparency
- Market discipline/disclosures
- Financial returns (dividends vs. surplus refunds)

This is because financial objectives are generally not aligned, consequently Surplus enhancing activities quite often reduce the final profits to Shareholders and potential for dividend payouts.

2. When Takafuls conduct cross-border transactions or open branches or joint ventures to expand horizons, there looms large the challenge of balancing various Shari'a issues of differing Takaful models, variations in product implementation, styles of risk management, lack of range of investment vehicles and even identifying and appointing local, qualified Shari'a scholars to advise the company. In addition, often poor/no audits occur on actual compliance within the Takaful to Shari'a principles espoused during business operations.

3. What "voice" – if any – to provide Policyholders in operations. To date, the author is unaware of any Takaful operator that gives an active role to Policyholders. Among the potential roles—representation on the Board of Directors (non-voting), representation on the Executive Operations Committee (observer status), representation on Committees of the Board or Executive Management, are some examples.

Other open areas for research are:

- What is proper mechanism to appoint a Takaful Operator (TO), or to dismiss a TO by Policyholders?
- Information asymmetry – ie TO has all data, and develops all financial statements whereas the Policyholder has no access to data and no role in financial decision-making
- Misalignment of incentives – Shareholders through the CEO they appoint set the rates, dividends and surplus policies without inputs from Policyholders. Note that some TOs charge their expenses and fees to the Policyholders' risk pool and also demand an Incentive bonus. (ie what's left for PHs?)
- Inherent Conflicts of Interest – in those circumstances where Shareholders make all business decisions, which gives rise to potential for a Conflicts of Duties – Shareholders serving own aims over those of PHs

Data compiled by global Takaful reports make clear that the nascent industry is growing rapidly – more than 25% per annum in some countries – and outstripping the growth of conventional insurance. Although, global Takaful contributions amount to less than 1 percent of insurance industry annual premiums of $4 Trillion dollars (2009), both the impressive rates of adoption of Takaful coverages and the proliferation of new Takaful entities assure that this segment of the industry will swell in breadth and importance. Eventually by capturing just 1% of global risk coverages, the Takaful volumes of contributions can reach $40 Billion annually worldwide, which would position Takaful alongside cooperative and mutual insurance as a truly global player and risk protection mechanism of choice for millions of policyholders. Thus, implementation by Takafuls of good corporate governance equally fair to shareholders and policyholders most assuredly will propel enduring growth for this sector.

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1 Stanford Professors working paper (2008) as reported by Eric Jackson, "Does Corporate Governance Impact Performance", July 2009.
2 Hawkamah Institute for Corporate Governance, Policy Brief, March 2009
3 Wilshire Report, "The CalPERS Effect- on Targeted Company Share Prices", July 31, 2009.
4 IBID, p. 4.
5 In Sudan, the original home to rediscovered Takaful (1979), several of the cooperative risk pools do not have shareholder capital and hence like mutuals appoint management from amongst members.
6 Excluding those standing Board members who coincidentally may also own a Takaful policy issued by their company.

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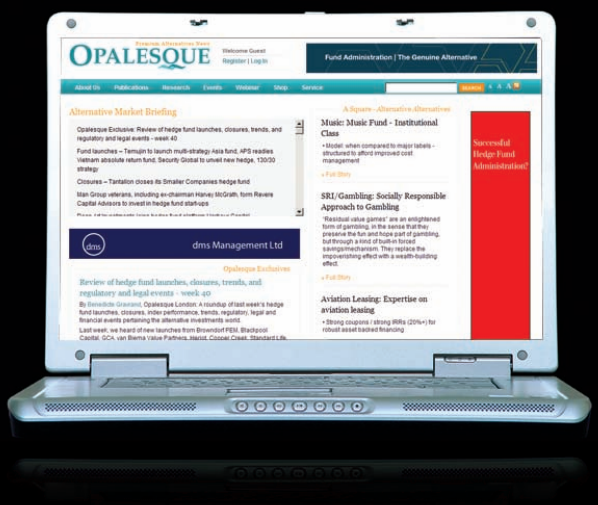

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