Corporate Governance for the Takaful Industry

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The past five years has seen a flourishing of Islamic, Shari'a compliant finance, with the industry growing at a rapid pace, with annual growth rates in excess of 15% p.a. In particular there has been a rapid growth in Shari'a compliant banking and in finance, with the Sukuk market challenging the conventional bond market as epitomized in the 2006 Dubai Ports $3.5 billion Sukuk which received some $11.4bn in subscriptions, the largest-ever oversubscription for a Sukuk.

Less known is the growth of the Islamic insurance and re-insurance sector, Takaful and re-Takaful. As the Arabic name indicates, it is based on the principle of cooperative insurance and mutuality. The global Takaful market is expected to grow by some 15-20% per annum to reach USD 7.4 billion in annual contributions by 2015. In the GCC, there are some 23 Takaful companies compared to 278 conventional insurance companies[1]. However, the rapid growth comes from a low base, with the insurance industry, both conventional and Shari'a compliant, being grossly underdeveloped in the Middle East North Africa region. The underdevelopment of the insurance industry in MENA is attributable to a number of factors including barriers to entry, restricted market access and protection of local insurers. The near absence of competition, restrictions on entry of foreign insurers and the dominance of government owned insurers and regulatory control of insurance pricing and products has led to expensive insurance and an absence of new products and innovation. Other structural factors have had a negative impact including inadequate development of property rights, their protection and enforcement; inadequate development of housing and mortgage markets and a lack of modern, enabling legal and regulatory infrastructure.

Poor corporate governance practices in the insurance industry across the MENA region is an important contributor to the underdevelopment of the insurance industry, resulting in limited investment in the industry and an absence of innovation in products and services. The MENA insurance industry is characterized by a "corporate governance gap", including concerns over the effectiveness of insurance supervision, divergent actuarial and accounting standards, capital adequacy and transparency, and technical solvency guidelines.

Empirical evidence supports the presumption that good corporate governance leads to better performance of companies. Overwhelmingly, institutional investors are willing to pay a premium for the shares of a well governed company over one considered poorly governed but with a comparable financial record[2], with premiums averaging 30% in

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[1] See the ARIG 2006 Report.
[2] See the 2002 McKinsey survey

Eastern Europe and Africa and 22% in Asia and Latin America. Better corporate governance practices results in better corporate credit rating by banks and rating agencies, leading to improved access to and terms of credit. This means lower borrowing costs for well-governed companies.

There are various models of Takaful, for instance the Modarabah model, the Wakalah model and the Waqf model. Good corporate governance framework is important to all models including to the nascent micro-insurance nascent sector. Adapting and implementing corporate governance codes and principles will enable the Takaful industry to access the financial markets, result in better performance and company valuations, and allow insurers to help develop the market and grow, by protecting the rights of stakeholders, notably, Investment Account Holders.

The guidelines laid down by the OECD and The International Association of Insurance Supervisors (IAIS) for corporate governance in the insurance sector serve as an industry benchmark for standard setting. These guidelines emphasize the importance of sound risk management and decision-making processes. They also include setting out the role and responsibilities of directors and ensuring that the rights of policyholders and shareholders are protected. Transparency, disclosure and regular reviews are also key requirements to facilitate good decision-making as well as protecting stakeholder rights.

The IFSB has developed seven guiding principles collectively referred to as the Guiding Principles**,** of prudential requirements in the area of corporate governance for institutions offering only Islamic financial services (IIFS). The Guiding Principles are divided into four parts: (i) general governance approach of IIFS; (ii) rights of investment account holders (IAH); (iii) compliance with Islamic *Shari'a* rules and principles; and (iv) transparency of financial reporting in respect of investment accounts. In particular, The IFSB CG Standard treats Investment Account Holders as quasi-shareholders. As an important example and in application of this principle, the DIFC's regulator, the Dubai Financial Services Authority (DFSA) regulatory module for Islamic Finance extends the obligations to provide periodic statements to Investment Account Holders setting out the performance of the investments being managed by the Mudarib on behalf of the Investment Account Holder.

The IAIS have also developed insurance core principles and methodology stating the essential principles that need to be in place for a supervisory system to be effective. In particular, ICP 9 deals with Corporate Governance and emphasizes that the corporate governance framework should recognize and protect rights of all interested parties. The board is the focal point of the corporate governance systems. It is ultimately accountable and responsible for the performance and conduct of the insurer. Delegation of authority to board committees, Shari'a committees or executive management does not in any way mitigate or dissipate the discharge by the board of directors of its duties and responsibilities. In addition to international standards, the responsibilities of the governing body must be consistent with the rules on governance structure established in the jurisdiction.

The IFSB & IAIS, have recently (August 2006) published an informative, "Issues in Regulation and Supervision of Takaful" which touches on corporate governance, noting that international corporate governance principles extend to the Shari'a board/committee. The latter should be an integral part of the internal governance structure of the insurer and ensure compliance with the Shari'a. Consideration also needs to be given to the relationship between the Shari'a committee and other governance structures of the company, to ensure that responsibilities are clearly and appropriately allocated.[3] In particular, relevant international standards should apply for the appointment, composition and report of the Shari'a committee. Specifically, the board nominations and compensation committee of the Takaful insurer should be responsible for nominating Shari'a committee members and their compensation based on appropriate 'fit and proper' criteria including professionalism and absence of conflicts of interest. The corporate governance framework should ensure the independence, confidentiality, competence of Shari'a scholars, as well as the consistency of Shari'a scholars' Fatwas (rulings).

There are additional specific challenges faced by the Takaful industry in terms of corporate governance. Internal governance issues to be addressed include the protection of minority shareholders, improved disclosure of risks, commingling of resources, balancing UIA holders' risks & rights and the rules for the utilization of reserve funds.

More generally, regulators need to impose mandatory, uniform financial reporting standards and disclosure requirements. In turn, the lack of reliable, timely, and consistent statistics on the Takaful Industry poses challenges to regulators, financial analysts, and the market and policy holders. In particular, the absence of quality statistics impedes the effectiveness of regulators and their ability to assess and mitigate individual insurer as well as systemic risk.

Hawkamah's strategy aims to bridge the corporate governance gap in the region, working with regional and international partners. In April 2007 Hawkamah signed an MOU with the 13-member Arab Forum of Insurance Regulatory Commissions (AFIRC) to promote and improve corporate governance in the region, and launched a task force to improve and harmonize corporate governance standards in the industry[4]. The Hawkamah-AFIRC Task Force brings together the insurance industry and regulators to develop a corporate governance framework for the insurance industry in the Arab world. The objectives of the Task Force is to undertake a corporate governance assessment of the insurance sector (including Takaful) in participating Arab countries; develop an insurance corporate governance policy brief to include conventional insurance and Takaful; develop corporate governance guidelines for the insurance sector; and build the corporate governance capacity of the industry.

Hawkamah has circulated a questionnaire survey to regulators and the insurance industry in the region in order to collect data and factual information, which will set the context and inform the discussions of the Task Force. A corporate governance policy brief will be

[3] See http://ifsb.org/index.

[4] For more information, please visit http://www.hawkamah.org/bridging_the_gap/networks/regional_task_forces/

developed as part of a public-private consultation, recommending actions and reforms applying to conventional insurance as well as to Takaful and Re-Takaful.

The growth of the Takaful business in the coming years is promising. Demand is growing as a result of strong demographics, sustained economic growth and the increase in public awareness of Takaful products, coupled with more efficient and diversified distribution channels that will provide greater access to a larger segment of the population. The Takaful sector has emerged as an important component of the financial system and has successfully integrated with the other components of the Islamic financial sector. The challenge will be to develop an enabling environment through the provision of a legal, regulatory, and supervisory and Shari'a framework to support the sound and efficient growth and development of the industry. Product innovation and excellent customer service will remain key enablers for future growth of the industry. Enhanced capacity and the availability of resources, particularly human capital, are essential in expediting the pace of progress in these efforts. For the regulators, the challenge lies in providing an enabling environment for removing the barriers to entry and competition, facilitating product innovation while at the same time, ensuring that good risk management principles and procedures are in place.

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