

Impact of the current global crisis on Islamic institutions and takaful companies

Mr Chakib Abouzaid, CEO of Takaful Re, analyses the impact of the current crisis and makes recommendations for strengthening the takaful industry in an extract from a paper presented in an Islamic Development Bank symposium.



Before analysing the impact of the current crisis on the insurance and takaful industry, we need to understand the causes of this global crisis. There are some observations on the economic level:

- The upward trend of the financial sector and use of derivatives and new vehicles for speculation can ultimately lead only to a bubble at the expense of the real economy, and this is impacting the productive sectors;
- The use of mathematical models in financial engineering cannot ignore the fact that the assumptions or even the results are only theoretical;
- The economy is always passing through cycles in the long term or what economists call "Kondratief cycles", within which there are other small cycles. These long cycles last around 50 years.
After the 1929 economic crisis and till the Second World War, the world witnessed economic collapses followed by a wave of industrialisation and a real economic boom based on creating wealth. After this period, as the growth pace was high, financial capitalism went back to speculation followed by 1987 crash, the 1999 dot-com fall and the current crisis.
- The collapse of the current financial market confirms that the economic cycle or cycles have become smaller than before in terms of the number of years as it was repeated three times during 20 years.
- The impact of the previous crisis did not affect all countries with the same intensity, but this is different nowadays with globalisation.

Negative impact

A recession is the biggest threat to companies, whether they are engaged in conventional insurance or takaful.

The need for funding AIG was not caused by its insurance activity but its involvement in subprime. Hence, the crisis was due to choice of an adventurous investment strategy. The AIG problems will affect shareholders who are ultimately individuals or institutions that have lost their investments of AIG share in the market.

Lehman Brothers' collapse has had an impact on the insurance sector through the contribution of some insurance companies in its capital. Perhaps the biggest loss was incurred by some giant French company which owned 20% of Lehman Brothers.

Insurance companies generate returns from underwriting and investments. The reduction in interest rates and the collapse of local and international stock markets will inevitably lead to lower investment income and the distri-

bution of their investments in shares. Mostly, these ratios do not exceed 25%.

The current crisis will have a direct negative impact on securing loans because of the insolvency of individuals and companies that buy credit insurance insures when buying goods or on exports. The payment default will generate losses for credit insurers. Any import or export or economic activity or construction cannot be carried without insurance. Corporations are obliged by law to provide health insurance for their employees, and any loans for buying a car or a house or building a factory require several types of insurance as life, fire and/or engineering.

The most important impact of the slowdown is the reduction of the savings by insurance companies, whether long-term savings in life insurance, bonds or portfolio investments or short or medium terms.

The fact that insurance companies are huge financial institutions makes them play an important role in investments which is the key in financing development. Any failure or activity reduction of an insurance company must have an impact on the financial sector and on economy as a whole.

The decision of the US administration to save AIG cannot be compared to the reluctance of the same administration to rescue Lehman Brothers, because AIG, as a huge global company, plays a major role locally for property and personal insurance, and also on the international level because of its presence in most of countries worldwide.

It is, thus, obvious that one of the sectors which will be impacted negatively is insurance because insurers are financial companies which play a key role in directing savings towards investments channels.

The possible impact on takaful

Takaful companies are not immune to the current economic crisis as they are part of the global insurance industry and because they are relying on the global reinsurance pricing. The negative impact is likely to be felt on two levels.

At the first level, the collapse of stock exchanges and the drop in the investment returns will negatively impact shareholders of takaful companies, and the fact that Shariah standards separate policyholders from shareholders' accounts, will see them incurring losses without being able to benefit from underwriting profits, which are exclusively and legitimately the property of policyholders. Therefore, this crisis must make us reconsider the distribution of profits among shareholders and policyholders, otherwise, the risk is to lose potential investors who could have established takaful companies. The drop in the investment returns

would negatively impact the policyholders' fund, and they may lose additional income which could help them to carry insurance or have some pricing flexibility, and face the gradual continued drop of insurance premium rates especially in the Gulf region.

At the second level, although the impact of the recession will affect takaful, this impact would be limited because takaful companies are based only in Southeast Asia and Arab Gulf countries.

The fact that a large number of companies are located in GCC countries enables them to benefit from the economic boom that Gulf countries witnessed in recent years and which will continue, thanks to the oil income and investment in infrastructure projects.

The pace of growth in the insurance sector in GCC and Iran in the recent period exceeded 25% in some countries; in other Muslim countries in Southeast Asia, the growth was lower. In Africa, the economic growth and the emergence of a middle class needing housing or life and property insurance is boosting insurance demand. However, this growth cannot hide the fact that insurance penetration for both conventional and takaful is still very low. The highest insurance penetration rate for an Islamic country is Malaysia with 5% in the GDP.

Positive effects

In view of recent trends, there are some positive sides of the crisis.

There is an increase in the demand for credit insurance in view of the fears of bankruptcy of the financial institutions and corporate clients; and this increase is supposed to increase rates for export credit insurance. The Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC) will be one of the beneficiaries.

Secondly, the AIG crisis situation may encourage international insurance companies to adopt conservative investment and underwriting policies, albeit less profitable ones. This is likely to raise rates in almost all lines of business to compensate investment losses and to protect companies from markets fluctuations.

Should we consider that the so-called soft market cycle is over? Not yet, and the 2009 renewal is confirming that. Some reinsurers have started speaking out about reducing capacities and/or the need for more underwriting discipline.

Thirdly, the current financial markets collapse will oblige insurance companies to reconsider their strategy and go back to their "core business" which is underwriting risks instead of investment and speculation.

Do all these potential positive impacts affect takaful industry? As mentioned earlier, the takaful industry is a part of the global insurance industry and, therefore, will be affected as negatively or positively as conventional companies. We, therefore, expect that international reinsurers will implement more discipline in pricing which should have a positive impact on Muslim markets, which will benefit takaful insurance companies directly.

Looking at the takaful map, we can observe that we are theoretically outside the areas that are affected more by the current crisis (ie North America, Europe, Japan and Korea). The incorporation of more than 140 takaful companies in Muslim countries largely protects them from the direct impact of the

financial crisis. Therefore, the current growth rate of 28% in recent years may continue. This optimistic outlook is because takaful companies are young, and not being large, their flexibility to face the crisis is very high in view of their investments in Islamic instruments exclusively. Moreover, takaful companies provide insurance for segments or customers looking for Shariah compliance.

Last but not the least, most of the newly established companies in Muslim countries are takaful, and the launch of new companies should continue, thanks to the dynamism and vitality of Islamic banks.

Takaful companies can benefit from short-term deposit returns due to their business models (funds segregation) and prudent investment policies, especially when investing policyholders' funds. They can also benefit from the recovery of sukuk and stock markets.

Impact on takaful

As mentioned earlier, the impact of the crisis will be limited to short-term investment profits.

However, the impact in the medium and long terms must be positive in terms of rates, thanks to the hard market and underwriting discipline. More importantly, the financial system failures and the uncertainty about its ability to create wealth from speculation should boost the Islamic financial banking model.

As part of the Islamic financial system, takaful must benefit from this new situation by differentiating itself from traditional business insurance, and must improve its services and products.

Suggestions for IDB

The Islamic Development Bank (IDB) can create companies in Muslim countries where there are no takaful companies, in order to promote professionalism and efficiency in the industry. IDB can also help to strengthen existing companies' capacities and select the best to support.

The IDB can impose a takaful clause for each loan or project it funds to encourage the growth of takaful. It can strengthen the role of AAOIFI and IFSB and make them the only reference for takaful companies, as well as encourage companies by supporting existing takaful associations and make them work under the same roof.

IDB can ensure that companies have a common database. Takaful Re has already initiated and published the *World Islamic Insurance Directory* in collaboration with *MiddleEast Insurance Review*.

Finally, IDB can lobby with Central Banks and Ministries of Finance to have a takaful legal framework and a central Shariah supervision board in each country. ■

