RISK MANAGEMENT: SYNERGY BETWEEN ISLAMIC FINANCE AND TAKAFUL (ISLAMIC INSURANCE)

By Omar Clark Fisher

Division Manager, Corporate Business Development
Takaful Taawuni, Bank Aljazira, Saudi Arabia

[Speech delivered at International Islamic Finance Forum, Dubai UAE, March 17-19, 2002]

Introduction

Risk management in the 1970s dealt with ‘passive risks’ and concerned itself more with measurement of risk exposures, a reduction of the costs of insurance buying and the promotion of broker relationships much more than close examination of the risks themselves.

During the decade of the 1980s, a shift occurred in business risk management whereby companies performed assessments of risks confronting their enterprise from competition, the rate of technological change, product liability risks, etc. and endeavored to coordinate an internal process to respond. Focus stayed on controlling losses and cost of insurance.

Since 1995, risk management thinking has spread to encompass a ‘prism of risks’ approach to evaluate impacts of risks on the business enterprise. The diagram below is an illustration of a Prism of Enterprise Risks:

Corporate risk managers today focus equally on the costs as well as the potential impacts that various risks can have on the enterprise operations, including bottom line profitability.
Most managers now face a tougher more competitive marketplace where there is a higher cost of “failure” and a narrower margin of “error” in decision-making. There are recent spectacular examples of this trend:

- BCCI 1991 - +$ 1 Billion in Losses
- Barings 1995 - +$1.4 Billion Losses and Bankruptcy
- LTC Management 1998 – lost $4.7 Billion in a few months yet over $45 Billion in Equity losses from stock valuation shrinkage!
- Sumitomo Bank - $1.8 Billion commodity trading losses
- World Trade Center Sept. 2001 – Property/Casualty damage and Business Income Losses exceed $100 Billion
- Enron Apr. 2002 – Pension losses alone surpass $400 Million
- WorldCom Jul. 2002 – Accounting irregularities breached public trust in the company and reduced shareholder value by $100 Billion.

In summary, the new premise in risk management is that the nature and impact of risks to the enterprise as a whole is paramount. Managers who wish to create value for their companies should care less about the costs of risk mitigation and more about the total net gain in shareholder value that is released when employing such risk management techniques. Taking a holistic viewpoint, shifts the risk management framework to an effective use of enterprise’s risk capacity—a combination of company’s capacity to absorb losses from unexpected (but planned for) events plus allocation of its capital required to transfer risks through purchase of insurance cover.

Consequently, there is a paradigm shift for decision-makers to become more informed, to perform analysis and evaluate options regarding:

- Which risks to avoid
- Which risks to transfer – at what price?
- Which risk to absorb – at what likely cost?

In brief, the shift in focus is to Risk Adjusted Return (RAR) vs. ROE or ROI, which measures may overlook important (and potentially devastating) risk factors impacting the enterprise, or the specific financing deal.
**Application of Risk Management to Islamic Asset Finance**

Typically, the dynamic for assessing a potential lucrative asset finance deal involves the following factors to consider:

If we utilize a Prism Approach to assessing risks of asset financing, then we might unbundled the risks in a transaction as follows:

**Strategic Risks** = Reputation/ Brand

**Hazards Risks** = Asset Damage

**Market-Finance Risks** = Cost of Funds/ Interest Rates

**Operations Risks** = Skills/ IT /Servicing

**Compliance Risks** = Shariah Consistency

---

**Synergy with Takaful**

Since the early 1980s, there has been gradually emerging a practice of risk mitigation which is Sharia compliant, called Takaful (Islamic Insurance). This system of insurance uses ancient practices known 14 centuries ago on the Arabia peninsula that were based upon mutual risk-sharing and group indemnification. Modern-day takaful operators now exist in more than XX countries and represent above $550 Million in gross annual written premiums. Takaful cover is available for both individuals/ families as well as businesses. In addition, Takaful products
fall into the traditional categories of Commercial Insurance (General Takaful) and Life Insurance (Family Takaful or Takaful Ta’awuni). Thus, potentially there are two main areas where Islamic finance and Takaful might cooperate: (A) Takaful (Islamic Insurance) can share in the risk of financing assets by covering certain specific risk elements, and (B) a bank or finance company can “cross-sell” Takaful products, which can provide attractive supplemental fee income.

Risk mitigation, as we have seen, is the key to unlocking higher yields from financing customer’s assets. Here a Takaful operator can be a banker’s “best friend” by permitting transfer to the Takaful of unexpected high severity losses from Hazards and Market Risks of certain types of Borrower defaults. In addition, when a bank derives additional fee income by acting as a broker/agent for Takaful products (ie. bank assurance, loan credit guaranties, etc.) without retaining any insurance risk itself, then such income can flow directly to augment its bottom line profits.

**Takaful Responses to Certain Types of Financing Risks**
There are five (5) key areas of risks that impact asset financings and below each one is examined in brief to demonstrate in what way Takaful cover might assist a bank or financing company extending asset financing to a customer.

<table>
<thead>
<tr>
<th><strong>Strategic Risks</strong></th>
<th><strong>Takaful Response</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Reputation</td>
<td>o Association with innovation in Islamic services</td>
</tr>
<tr>
<td>• Investor Support</td>
<td>o None</td>
</tr>
<tr>
<td>• Brand Name Position</td>
<td>o None</td>
</tr>
<tr>
<td>• Customer Support/Access/Convenience</td>
<td>o Customer identifies with Islamic finance, ownership and builds Loyalty</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Hazard- Asset Risks</strong></th>
<th><strong>Takaful Response</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Physical Damage</td>
<td>o Property- General Takaful</td>
</tr>
<tr>
<td>• Liabilities/Casualty</td>
<td>o Liability – General Takaful</td>
</tr>
<tr>
<td>• Business Interruption</td>
<td>o None</td>
</tr>
<tr>
<td>• Asset Quality- Residual Value Risk</td>
<td>o None [could design a “put” option as residual value insurance</td>
</tr>
<tr>
<td>• Term-Useful Life</td>
<td>o None</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Financing/Market Risks</strong></th>
<th><strong>Takaful Response</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Interest Rates – Cost Of Funds</td>
<td>o None</td>
</tr>
<tr>
<td>• FX- Currency Risk</td>
<td>o None</td>
</tr>
<tr>
<td>• Credit Quality - Payment Risk</td>
<td>o Loan Repayment Guaranty Takaful cover</td>
</tr>
<tr>
<td>• Risk-Reward Ratio (ROI)</td>
<td>o None</td>
</tr>
<tr>
<td>• Political Risks</td>
<td>o IDB Takaful cover for Commodity trading</td>
</tr>
<tr>
<td>• Penalties for Default</td>
<td>o None</td>
</tr>
</tbody>
</table>
Operations Risks

- Performance Risks - Unwinding the deal
  - None
- Security Risk/ Collateral
  - Loan Repayment Guaranty Takaful Cover
- Ownership Risk - Perfection of title
  - None [could design Title insurance]
- Servicing Risk- timely Repayments
  - None
- Employees – Skills
  - Keyman Takaful cover
- Employees – Retention
  - Group Retirement/Pension Takaful Plan
- Employees – Productivity
  - Group Retirement/Pension Takaful Plan

Compliance Risks

- Overall Sharia Compliance
  - Takaful is Sharia approved consistency with Holy Quran and Sunnah principles
- Choice of Contract
  - Takaful fully compatible with Islamic Financing [Bank Aljazira uses Al Wakala Contract]
- Source of Funds
  - None

It is axiomatic to say that risk and uncertainty increase over time across each of the five areas described above. Thus, banks and financing companies that offer financing terms greater than five (5) years need to acquaint themselves with risk-sharing tools such as Takaful cover.

The chief benefits of using Takaful cover to complement an Islamic asset financing package are (a) reduction in risk levels and uncertainty to make cash flows more predictable, and (b) enhancement of an enterprise’s capacity to absorb losses should they occur due to the transfer of certain risks to a Takaful operator.

Practical Examples of Takaful Cover

Perhaps using two examples from Bank Aljazira’s range of Corporate/Group Takaful products will help to clarify how this works. One illustration derives from an Auto Financing portfolio of SR 10.0 Million, which has on average a 3% default rate [equal to 300,000 annually] and on average margin of profit of 12%. Application of Bank Aljazira’s Loan Repayment Guaranty plan on the financing portfolio might result in an annual premium of SR 100,000. There is modest reimbursement fee income to the financier of SR 50,000 for performing some customer record-keeping, so the net premium costs is SR 50,000 annually. The net profit would be SR 900,000 annually, or 9% yield.

Under the Loan Repayment Guaranty cover, any eligible claim relating to a defaulted borrower would be paid by the Takaful Operator so that the remaining balance of the indebtedness is fully repaid to the financier. Assuming that defaults were reduced by 50%,
the ROI improves for the financier by 11%, from SR 900,000 to SR 1,000,000. Assuming that the defaults were reduced only by 35%, the ROI improves by 6.1%, from SR 900,000 to SR 955,000.

Among the advantages to the financier of such an arrangement are:

- ROI Bottom Line increases – 6% to 11%
- Defaults reduced by 35% to 50% *
- Marketing and Advertising benefit to Customers from Takaful cover
- Additional source of Fee Income
- Reduction in Costs and Problems of Repossession of defaulted assets

* Note: assumes 35% to 50% of defaults are due to death or disability of the borrower.

The second example involves asset financing to a sole proprietorship who has provided a personal guaranty in support of the credit financing package. How will the financier respond if this key person dies, becomes disabled and his family refuses to repay the outstanding obligation? By application of Takaful Ta’awuni Keyman Cover which affords risk protection to that sole proprietor in the amount of the outstanding indebtedness as it is amortized, the financier can increase his security, reduce the default ratio and improve the overall profitability of its financing portfolio.

In the event of the death or disability of that key individual, the Takaful Operator rapidly repays the remaining obligation (both principal and profit if desired) to the financier without any legal entanglements, costly or delayed collections and avoiding the unpleasant and troubling task of seeking money from a grieving family.

**Conclusions**

Longer term asset financings involve considerable risks – some of which are tricky and difficult to quantify or mitigate using conventional credit hedging techniques. Moreover, Islamic financial institutions are enjoined to conduct all business activities strictly in compliance with Sharia principles. Modern risk management concerns the entire enterprise and its capacity to absorb losses. Enterprise risks can be categorized into five (5) key areas: Strategic Risks, Hazard/Asset Risks, Financing/Market Risks, Operations Risks, and Compliance Risks. Takaful cover, a newly emerging alternative form of insurance, fulfills the requirement that an “insurance wrapper” or risk-sharing mechanism be Islamicly acceptable. Takaful products can respond in each of the five key areas, although some specific risks do not yet have a Takaful counterparty [see the description in the risk tables above]. Takaful cover complements Islamic asset financing by:

- Being Sharia Compliant
- Reducing Defaults, Bad Loans/Leases and Write-offs
- Minimizing Repossessions of Defaulted assets
- Improving a Financier’s Marginal Profitability
- Enhancing the Credit Quality of the financing portfolio
• Increases Customer Satisfaction and Loyalty

Further, in cases where a financier elects to provide the Takaful products on an agency basis, these Takaful insurance solutions can be source of additional fee income. Integrating Takaful cover with Islamic asset financing is a classic application of “win-win” business—creating a new synergy for banks, for Takaful Operators and for their customers.

~ end~

BIBLIOGRAPHY


- Insurance Finds a Blend of Innovation and Tradition, Gerry Dickinson
- Value, Risk and Control: A Dynamic Process in Need of Integration, Philippe Jorion
- Insurance and Finance: New Vehicles for Driving Value, Neil Doherty
- Lowering Exposure by Spreading the Risk, Mike Hanley
- Capital Ideas that Face Dissension in the Banks, Tim Shepard-Walwyn
- Issue of the Moment: The Rise of Risk Management, Ben Hunt
- Why Risk Management is Not Rocket Science, Rene Stulz
- Reflections of a Risk Manager, Stephen Thieke
- Philosophies of Risk, Shareholder Value and the CEO, Rory Knight

Assessment of Political Risks in Project Finance, Omar Clark Fisher, ADL Magazine, 1984