THE CHARTERED INSURANCE INSTITUTE

590

Advanced Diploma in Insurance

Unit 590 – Principles of Takaful

April 2011 Examination Guide

SPECIAL NOTICES

Candidates entered for the October 2011 examination should study this examination guide carefully in order to prepare themselves for the examination.

Practice in answering the questions is highly desirable and should be considered a critical part of a properly planned programme of examination preparation.

590 – Principles of Takaful

Contents

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Telephone: 020 8989 8464
Fax: 020 8530 3052
Email: customer.serv@cii.co.uk

IMPORTANT GUIDANCE FOR CANDIDATES

Introduction

The purpose of this Examination Guide is to help you understand how examiners seek to assess the knowledge and skill of candidates. You can then use this understanding to help you demonstrate to the Examiners that you meet the required levels of knowledge and skill to merit a pass in this unit. During your preparation for the examination it should be your aim not only to ensure that you are technically able to answer the questions but also that you can do justice to your abilities under examination conditions.

Before the examination

Read the Advanced Diploma in Insurance information for candidates and important notes for candidates

Details of administrative arrangements and the regulations which form the basis of your examination entry are to be found in the current Advanced Diploma in Insurance Information for Candidates and important notes for candidates, which is *essential reading* for all candidates. It is available online at www.cii.co.uk or from Customer Service.

Study the syllabus carefully

It is crucial that you study the relevant syllabus carefully, which is available online at www.cii.co.uk or from Customer Service. All the questions in the examination are based directly on the syllabus. *You will be tested on the syllabus alone,* so it is vital that you are familiar with it.

Read widely

It is vital that your knowledge is widened beyond the scope of one book. *It is quite unrealistic to expect that the study of a single coursebook will be sufficient to meet all your requirements.* While books specifically produced to support your studies will provide coverage of all the syllabus areas, you should be prepared to read around the subject. This is important, particularly if you feel that further information is required to fully understand a topic or an alternative viewpoint is sought. The reading list which can be found with the syllabus provides valuable suggestions.

Make full use of the Examination Guide

The best way to understand what the examiners require is to study the CII Examination Guides. You can purchase copies of Examination Guides online at www.cii.co.uk. CII members can download free copies of past Examination Guides online at www.cii.co.uk/knowledge. This guide and previous Examination Guides can be treated as 'mock' examination papers, attempting them under examination conditions as far as possible and then compare your answers to the model ones. The examiner's comments on candidates' actual performance in each question should be noted carefully.

Understand the nature of assessment

Assessment is by means of a three-hour written paper. This Examination Guide contains a full examination paper and model answers. The model answers show the types of responses the examiners are looking for and which would achieve maximum marks. *However, you should note that there are alternative answers to some question parts which would also gain high marks.* For the sake of clarity and brevity not all of these alternative answers are shown.

Know the structure of the examination

Familiarise yourself with the structure of the examination paper and the time allowed to complete it. This information can be found on the question paper included within each Examination Guide.

In the examination

Assuming you have prepared adequately, you will only do justice to yourself in the examination if you follow two crucial common sense rules:

1. **Spend your time in accordance with the allocation of marks as indicated on the paper.** The maximum marks allocated to each question and its constituent parts are given on the paper; the number of marks allocated is the best indication of how much time you should spend on each question. If a question has just two marks allocated, there are likely to be only one or two points for which the examiner is looking, so a long answer is a waste of time. Conversely, if a question has 12 marks allocated, a couple of lines will not be an adequate answer. Always remember that if the paper is not completed, your chances of passing will be reduced considerably. Do not spend excessive time on any one question; if the time allocation for that question has been used up, leave some space, go on to the next question and only return to the incomplete question after you have completed the rest of the paper, if you have time.

2. **Take great care to answer the precise question set.** The model answers provided in this Examination Guide are quite focused and precise; alternative answers will only be acceptable if they still answer the question. *However brilliantly a candidate writes on a particular topic, if it does not provide a satisfactory answer to the precise question as set, the candidate will not achieve the marks allocated.* Many candidates leave the examination room confident that they have written a 'good' paper, only to be mystified when they receive a disappointing result. Often, the explanation for this lies in a failure to think carefully about what the examiner requires before putting pen to paper.

Order of tackling questions
Tackle the questions in whatever order feels most comfortable. Generally, it is better to leave any questions which are felt to be very challenging until the more familiar questions have been attempted, but *remember not to spend excessive time on the questions you are most confident about.*

Answering different question parts
Always read all parts of a question before starting to answer it, otherwise, you may find that after answering part (a), the answer you have given is really more appropriate to part (b) and it would be necessary to duplicate much of what has already been written. The examiners will normally only give credit for an answer if it is contained within its correct question part.

Handwriting
Provided handwriting is legible, candidates will **not** lose marks if it is 'untidy'. *It is strongly recommended that candidates do not write in block capitals,* because they will be slowed down so much by doing so.

Answer format
Unless the question requires you to produce an answer in a particular format, such as a letter or a report, *you should use 'bullet points' or short paragraphs,* since this allows you to communicate your thoughts in the most effective way in the least time. The model answers indicate what is acceptable for the different types of question.

Calculators
If you bring a calculator into the examination room, it must be a silent battery or solar-powered **non-programmable** calculator. The use of electronic equipment capable of being programmed to hold alphabetical or numerical data and/or formulae is prohibited. You may use a financial or scientific calculator, provided it meets these requirements. *It is important to show all the steps of your calculation in your answer.* The examination is testing your ability to carry out all the appropriate steps in calculating a value. A proficient mathematician is someone who follows the correct method, i.e. carries out the appropriate steps. The majority of the marks will be allocated for demonstrating the correct method of calculation.

After the examination

All examiners who mark Advanced Diploma in Insurance answer books are either active practitioners in the financial services industry or are experts on the subject. They have been specially trained to mark papers using a detailed marking scheme, the model answers in examination guides are based on those marking schemes.

After each examiner has provisionally marked a small number of answer books, there is a co-ordination meeting of all the examiners at which the Senior Examiner goes through the marking scheme with the other examiners. Based on the feedback from the initial marking, the detailed marking scheme is finalised.

The marking of each examiner is closely monitored by a Senior Examiner during the marking period and sampling of marked answer books is carried out.

After all the answer books have been marked, a moderation meeting is held, at which all available statistical information is considered, together with the views of the Senior Examiner and other assessment experts. At the meeting a pass mark is set which should ensure that the standard of knowledge and skills required to pass the paper is comparable with that of previous papers. All candidates at or above the agreed pass mark will pass: the CII does not operate a quota system whereby only a fixed percentage of candidates can pass a paper.

EXAMINERS' COMMENTS

In Part I, all questions were straightforward in nature, and most candidates provided the necessary information to achieve the marks. Some candidates did struggle to write good answers, which demonstrated a lack of preparation.

Part II was not well answered. It is essential that candidates give due focus towards understanding the components of the Takaful balance sheet.

In Part 3, well-prepared candidates achieved high marks.

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Advanced Diploma in Insurance

Unit 590 – Principles of Takaful

April 2011 examination

Instructions

- Three hours are allowed for this paper.
- **Do not begin writing until the invigilator instructs you to.**
- **Read the instructions on page 3 carefully before answering any questions.**
- Provide the information requested on the answer book and form B.
- You are allowed to write on the inside pages of this question paper, but you must **NOT** write your name, candidate number, PIN or any other identification anywhere on this question paper.
- The answer book and this question paper must **both be handed in personally by you** to the invigilator before you leave the examination room. **Failure to comply with this regulation will result in your paper not being marked and you may be prevented from entering this examination in the future.**

Unit 590 – Principles of Takaful

Instructions to candidates

Read the instructions below before answering any questions

- **Three hours** are allowed for this paper which carries a total of 200 marks as follows:

Part I	8 compulsory questions	48 marks
Part II	1 compulsory question	38 marks
Part III	3 questions selected from 5	114 marks

- You should answer **all** questions in Part I, the compulsory question in Part II and three out of the five questions in Part III. The number of marks allocated to each question is given next to the question and you should spend your time in accordance with that allocation.
- You are advised to spend no more than 45 minutes on Part I.
- Read carefully all questions and information provided before starting to answer. Your answer will be marked strictly in accordance with the question set.
- You may find it helpful in some places to make rough notes in the answer booklet. If you do this, you should cross through these notes before you hand in the booklet.
- It is important to show all steps in a calculation, even if you have used a calculator.
- If you bring a calculator into the examination room, it must be a silent battery or solar-powered non-programmable calculator. The use of electronic equipment capable of being programmed to hold alphabetic or numerical data and/or formulae is prohibited. You may use a financial or scientific calculator, provided it meets these requirements.
- Answer each question on a new page and leave six lines blank after each question part.

Part I

Answer ALL questions

Note form is acceptable where this conveys all the necessary information

1. State **six** marketing characteristics of Islamic and Conventional Insurance business. **(6)**

2. Explain how conventional insurance and Islamic insurance manage risk differently. **(6)**

3. State **six** different ways of defining ‘risk’. **(6)**

4. Explain the difference between a pure risk and a speculative risk. **(6)**

5. **(a)** State **three** halal investment channels available to an Islamic insurance company. **(3)**

(b) Identify **three** potential issues that could affect the Islamic insurance company investment portfolio. **(3)**

6. Define Deya and explain how social funds were created using Deya. **(6)**

7. Identify **six** limitations that would typically disqualify a risk as uninsurable. **(6)**

8. Explain the concept of cooperation and its relevance in Islamic insurance. **(6)**

Part II

Compulsory question
This question is worth 38 marks

9. **(a)** CBA Islamic Insurance Company is based in Bahrain. As per the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) financial accounting standards, CBA Islamic Insurance Company is due to prepare the company's set of financial statements for 2010.

Using the information below, prepare the CBA Islamic Insurance Company's financial statement of policyholders' revenues and expenses as at 31 December 2010. **(26)**

Item	**Debit (BHD)**	**Credit (BHD)**
Gross contributions		300,000
Acquisition Cost	30,000	
Remuneration of CBA for managing insurance operations		75,000
Total policyholders' investment income		2,000
Reinsurers share of contributions	210,000	
Reinsurance Commissions		63,000
Paid Claims	20,000	
Unearned contributions	40,000	
Recovered claims from reinsurers	15,200	
CBA share for managing investments		200
Outstanding claims-end of period	40,000	
Recoverable outstanding claims from re-insurers		30,000

(b) Identify **twelve** General Disclosure Requirements notes, which Islamic insurance companies need to accompany their financial statements. **(12)**

Part III

Answer THREE of the following FIVE questions
Each question is worth 38 marks

10. Outline the titles of the main elements of a commercial insurance transaction, and for **each**, provide an insight into how Takaful is relevant. Your answer must be based on:

- contract between insurer and insured;
- compensation for loss paid from collective fund;
- insurance contractor policy;
- risk contingent;
- major player in modern economy. **(38)**

11. Evaluate the responsibilities and challenges for Shariah Supervisory Boards and how the Shariah compliance officer assists them. **(38)**

12. Discuss the challenges for the future of Takaful. **(38)**

13. Analyse and evaluate the main principles of the underwriting policy of an Islamic insurance company. *In your answer, you must also refer to rating, terms and conditions.* **(38)**

14. Identify and summarise the **four** models used in Takaful to provide for clear segregation between the Participant and the Operator. **(38)**

NOTE ON MODEL ANSWERS
The model answers given are those which would achieve maximum marks. However, there are alternative answers to some question parts which would also gain high marks. For the sake of clarity and brevity not all of these alternative answers are shown. An oblique (/) indicates an equally acceptable alternative answer.

Model answer for Question 1

Candidates would have gained full marks for any six of the following:
- Intangibility.
- Transience (except long-term business).
- Inconsistent specifications.
- Regulation.
- Personal Interaction.
- Staff quality is critical.
- No physical distribution channels.

Model answer for Question 2

Conventional insurance is a risk-transfer mechanism. The covered risk is, by contract, transferred from the insured to the insurer in return for a premium.

Islamic insurance is a risk-sharing mechanism. The contract providing for the risk-sharing is a unilateral contract between the Participant and the Participants' Fund where the Participants all share each others' risks by donating contributions into the Fund.

Model answer for Question 3

Candidates would have gained full marks for any six of the following:
- The possibility of loss.
- The probability of loss.
- Peril.
- A hazard.
- The property or person exposed to damage or loss.
- Potential losses.
- Variation in potential losses.
- Uncertainty concerning loss.

Model answer for Question 4

Risks have generally three eventual outcomes:
- Gain.
- Loss.
- No change.

- A speculative risk is one where all three outcomes are possible.
- A pure risk is one where only the "loss" and "no change" outcomes are possible.

Model answer for Question 5

(a) *Candidates would have gained full marks for any three of the following:*
- Real estate investment.
- Direct investment in all Halal commercial and industrial activities.
- Profit sharing (Mudaraba), trusts, deposit with Islamic banks.
- Skuk.
- Any other Islamic funds or transactions which are interest-free activities.

(b) *Candidates would have gained full marks for any three of the following:*
- In some countries the Islamic insurance companies may have to invest in interest bearing deposits in order to comply with local regulations. In this case interest earned on the deposit must be distributed to charities and cannot be added either to policyholders or shareholders accounts.
- Under modes of Islamic investment there is no minimum guaranteed return on investment which can be offered to life assurance policyholders like a conventional insurance company.
- Some markets have limited access/choice in Islamic Investment in comparison with Conventional Investments.
- In certain cases, more time and effort is needed in arranging Islamic Investment in comparison with Conventional Investments.

Model answer for Question 6

Deya, in Shariah, is blood money in the event of unintentional killing. The amount is equal to 100 camels (or any equivalent value), payable by the killer to the victim's family.

Acqela is the Deya amount collected by the family or tribe of the killer, in the event that the killer is unable to afford the Deya amount.

In event that the killer is unknown, the Deya amount is paid to the family of the victim from the Qasama fund. This is paid into by the tribe members to cater for such cases where the killer is unknown.

Model answer for Question 7

Candidates would have gained full marks for any six of the following:
- No monetary value.
- No insurable interest (as required by law).
- Illegal or unlawful activity.
- Vice or dishonest behaviour contributing to the risk (i.e. fraud).
- Certain catastrophic risks such as nuclear accident, famine or war.
- Public policy exclusions such as fines or criminal acts.
- Usual wear and tear and depreciation of property.
- Other factors or limitations that contribute to making a risk insurable are delay, vermin, market agreements, government confiscation or authority etc.

Model answer for Question 8

Generally, a person is not able to cater for all risks he/she may face during his/her lifetime. Practically, no one can individually insure or secure him/herself against all forms of risks and losses.

Therefore, cooperation among people is inevitable to jointly secure or protect their collective interests against various forms of risks and losses. Islam supports cooperation as a natural social instinct whereby the contributions of many protect the losses of few (law of large numbers), thus protecting all those cooperating against their individual risks collectively.

Model answer for Question 9

(a) Insurance Company Statement of Policyholders' Revenues and Expenses for the year 2010

	(£)
Insurance Revenues	
Gross Contributions	300,000
Less: Reinsurers' Share	(210,000)
Net Retained Contributions	90,000
Less: Changes in unearned contributions	(40,000)
Earned Contributions	50,000
Reinsurance Commissions	63,000
Total Insurance Revenue	113,000
Insurance Expenses	
Paid Claims	20,000
Recovered claims from reinsurers	(15,200)
Net Paid Claims	4,800
Outstanding Claims-end of year	40,000
Less: Recoverable Outstanding Claims from reinsurers	(30,000)
Net Outstanding Claims	10,000
Remuneration of company for Managing insurance operations	75,000
Acquisition Cost	30,000
Total Insurance Expenses	119,800
Net Loss from Insurance Operations	(6,800)
Investment Income	
Investment Income	2,000
Less: Owners equity share for Managing investment portfolio	(200)
Net Investment Income	1,800
Loss of Revenue over Expenses	(5,000)

(b) Islamic Insurance Companies need to make a number of disclosure notes to accompany their financial statements including the following:

- The company shall include comparative financial information in all of its financial statements, at least for the current and previous year.
- It shall be noted that, "notes to the financial statements form an integral part of the financial statements."
- The financial statements shall disclose all material information that is necessary to make the financial information relevant, adequate and reliable to their users.
- The financial statements shall disclose basic information about the Islamic Insurance Company including its name, country of incorporation, legal form, formation date, activities and the major services it provides, location of head office, branches, names of subsidiaries, percentage ownership in each subsidiary, names of subsidiaries whose financial statements are not consolidated and names of associates and affiliates.
- Names of the members of the Shariah Supervisory Board 1 and the board role and authority.
- The authority responsible for the supervision of the company.
- Disclosure of the reporting currency and accounting methods in use for the translation of foreign currency balances.

Disclosure of significant accounting policies to:

- Recognise earned contributions.
- Recognise outstanding claims and claims incurred but not reported.
- Recognise unearned contributions.
- Recognise insurance business acquisition cost.
- Recognise commission earned from re-insurers.

Disclosure of significant accounting policies relating to:
- The translation of foreign currency assets and liabilities to local currency.
- The amortisation of development cost.
- The consolidation of subsidiaries.
- The choice of an acceptable accounting alternative, for example, choice of depreciation method.
- The accounting policies/methods which are not consistent with the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) financial accounting standards.
- The revaluation of assets.

- Disclosure of unusual supervisory restrictions.
- Disclosure of earnings/expenditure prohibited by Shariah.
- Disclosure of concentration of asset risks.
- Disclosure of risks associated with assets/liabilities which are denominated in foreign currency.
- Disclosure of amounts recoverable from re-insurers.
- Disclosure of contingencies not recognized in the statement of financial position and outstanding financial commitments.
- Disclosure of restricted assets or assets under pledge.

Disclosure of accounting changes including:
- Changes in accounting policies.
- Changes in accounting estimates.
- Correction of material errors in prior periods.

- Disclosure of the party managing insurance operations, the contract in use and the remuneration he receives.
- Disclosure of the party managing policyholders' investment funds, the contract in use and the bases for profit allocation.
- Disclosure of the basis for allocating surplus among the policyholders.
- Disclosure of related party transactions.
- Disclosure of transactions with External Auditors and/or members of the Shariah Board.
- Disclosure of the concentration of insurance and re-insurance risks.

Model answer for Question 10

Contract between insurer and insured
Insurance represents a contract between an insurer and individual or business party that provides financial compensation for the effects of a financial loss resulting from a possible, but unpredictable event.

In Takaful, there are two contracts:
- Unilateral contract between the Participant and the Participants' Fund. This is an important aspect of Takaful whereby the Participants' Fund is, in effect, owned by the Participants and not any other party.
- Bilateral contract between the Participants' and the Takaful Operator. This contract allows the Takaful Operator to manage the risks of the Participants, i.e. underwriting, management of the portfolio of risks, claims management, administration of the Fund, etc.

Compensation for loss paid from collective fund
Compensation for losses is covered from a collective fund of the portion of premiums paid by the insured persons. The transaction of the premium is from one party, namely the insured, transferred to another party, namely the insurer. The transaction of the claim payment is from one party, namely the insurer, transferred to another party, namely the insured.

In Takaful, both these transactions are implemented between the Participant and the Participants' Fund, i.e. the unilateral contract. It is important to note that the Takaful Operator may manage and administrate such transactions, but the Takaful Operator is not a party to these transactions.

Insurance contractor policy
A contract of insurance is commonly known as a policy which specifies the terms under which an insurer agrees to compensate the insured policyholder for loss in consideration of payment of a stated premium.

In Takaful, the only difference, again, is that this policy contract is a unilateral contract between the Participants and the Participants' Fund, hence the compensation is part of a risk-sharing mechanism and, of course, we have contributions as opposed to premiums.

Risk contingent
The insurance contract must be risk contingent, i.e. the event or occurrence being covered must be unpredictable, sudden, accidental, unforeseen and beyond human control. The same applies to a Takaful contract.

Major player in modern economy
Insurance is one of many risk management solutions, based on a risk-transfer mechanism. It is a major player in the modern economy as it provides for the compensation of property which is lost or destroyed, and also is a vehicle of maintaining the 'purchasing power' of parties who face the affects of illness, injury or death. The insurance we use today started approximately 400 years ago.

Takaful is another one of many risk management solutions, based on a risk-sharing mechanism. Takaful started approximately 30 years ago. As a risk management solution, Takaful is gaining pace and has similar benefits to other risk management solutions.

Model answer for Question 11

The responsibility of Shariah Supervisory Boards (SSB) is not limited to veto, restrict or consent to the insurance transactions. It goes beyond this; to support, assist and guide the insurance company whenever the Shariah stand on any transaction has to be identified.

Supervisory role
The supervisory role of SSB can be summarized as below:

- Reviewing all insurance contracts, clause and reinsurance treaties used by the company to insure their compliance with the Shariah Standard, and set out any recommendation to make them in the line with Shariah requirements.
- Reviewing all investment transactions for Shariah conformity and ensuring that they are free of Riba, Gharar and Maiser.
- Answering any questions by the board of directors or company employees in relation to Shariah matters.
- Supervising the compliance with the Shariah standards and requirements.
- Reviewing new Fatwas concerning insurance, issued by any recognised councils or academies and updating the company with its impact on the company operations or insurance terms and conditions.

Innovative role

- In fact Shariah is by means of Ijtehad adaptable to new circumstances.
- Therefore Shariah scholars can search for solutions to current problems, offer constructive and creative ideas, and develop new products.
- However, the designing of products themselves (clauses, rates, warranties etc.) is a technical issue. It must be done by the insurance experts and underwriters as it needs good grasp of underwriting.
- After finishing the product designing, SSB has to review the final product for Shariah compliance. Scholars either approve it or state further steps to be taken.

Supplementary roles
In addition to the above mentioned roles there are some other supplementary roles to be played by SSB in insurance company:

- Working with company accountants to calculate the Zakat on shareholders and policyholders funds.
- Supporting the training manager in estimating the Shariah training needs of the employees and preparing the relevant training materials.

Challenges for Shariah Supervisory Board (SSB)

- Conflicts could possibly take place between SSB on the one hand and insurance company officers and senior managers on the other, because of Shariah scholars' lack of technical information and poor Shariah background on the part of the latter.
- Skilled scholars who are eligible to be SSB members are still a rarity. Most of the Shariah Supervisory Boards SSB over the world are monopolised by a relatively low number of scholars.
- If the SSB were not able to suggest realistic solutions for clients' needs, they would lose the policyholders' trust. This would have a negative impact on the Islamic insurance company reputation and image.
- There is no formal internationally-recognised and internationally-accredited school that provides specialized training for Shariah scholars.

The SSB arranges regular meetings to discuss company problems and questions, but they are not involved in day-to-day affairs of Islamic insurance practice. So the SSB needs a representative to act as its arm in day-to-day operations. This role is usually delegated to the Shariah compliance officer (SCO) who is an integral part of the governance of the insurance company. The place of the SCO in the company organisational chart is debatable. It might be as a part of the internal audit department or as a separate position whose authority is equivalent to the authority of the internal auditors.

The SCO needs a strong background in Shariah as well as the day-to-day application of insurance. The main responsibilities of the SCO are:

- to ensure that day-to-day operation is in line with Shariah standards and SSB guidelines;
- acting as a liaison officer between company employees and the SSB, he prepares the questions to be answered by the SSB and prepares periodic reports about the operation to be submitted to the SSB;
- to keep continuous and clear communication with the SSB, and to communicate any problem or questions that need a prompt answer;
- not allowed to rule or provide Fatwa.

The SCO plays a vital role in eliminating any communication problem or conflict between SSB and company management. All disputes between SCO and management should be reported to SSB.

Model answer for Question 12

Among other challenges that need to be addressed by Takaful industry leaders are:

- Awareness and marketing of Takaful.
- Education of the end-user (the insured or Participant).
- Broadening distribution channels beyond the agency system, including bancassurance.
- Promoting regional and international Takaful co-operation and alliances particularly through establishment of Takaful Associations or Unions.
- Expanding and enhancing the capacity for Retakaful globally.
- Addressing the current skills shortages, including skilled underwriters and other technical personnel, by increased training and re-training.
- Cross-training Takaful managers to be knowledgeable about Islamic finance as well as risk management (Takaful).
- Modernisation of data-processing systems and interface between conventional software and Islamic values.
- Development and promulgation of Takaful standards for accounting, management operations and auditing.
- Improving Takaful competitiveness as compared with mutuals as well as with conventional, stock insurance companies.
- Refine regulatory rules to reflect the unique circumstances of Takaful companies without weakening risk management and financial stability standards to provide proper levels of consumer protection in terms of risk and disclosure in policy wordings.
- Modifying supervisory rules to allow variant asset risk profiles for Takafuls as different from conventional insurers due to different capital structure and lower risk appetite.
- Adjustments to rating methodologies to account for Takaful risk pool's lower financial security - due to a lack of diversification, short operating history and uncertainty about circumstances of Qard Hassan from shareholders to cover deficits.
- Reduce the existing concentration of investment risks by Takafuls because of a narrower range of available investment assets that are Shariah compliant.
- Build effective responses to strong competition from conventional insurers, which may be able to earn greater investment returns and have greater economies of scale, many of whom have launched Takaful product lines.
- Modest levels of capitalisation among many Takaful businesses, especially within the Takaful fund, can limit capacity to take on risks and delay realisation of surplus for policyholders.
- Immature enterprise risk management systems and trained personnel can postpone grappling with requirements of Basel II (2010) to increase capital and operate under risk-weighted capital rules which can disadvantage Takafuls.
- Develop suitable business processes and IT software/infrastructure which is Takaful friendly, rather than being forced to adapt to conventional insurance systems.
- How to evaluate the "contingent guarantee" from shareholders (Qard Hassan) to cover a deficit in the risk pool and what are implications for capital adequacy and solvency margins.

Model answer for Question 13

Underwriting is defined by as 'the process of selecting policyholders by recognising and evaluating risk, setting prices and deciding upon the appropriate terms and conditions'. The underwriter decides upon:
- risk acceptance;
- risk rating: setting insurance price;
- terms and conditions of cover.

In Islamic insurance all technical aspects of conventional underwriting process are applicable. The difference is in risks acceptance criteria, some terms and conditions of insurance policies.

The underwriting policy is formed and differs from one insurance company to another depending upon:
- business requirements;
- customers' needs;
- risk exposure;
- underwriting cycle condition (Soft or hard market);
- legal and ethical considerations.

The Islamic insurance company in its underwriting policy focuses on solidarity among the participants as well as shareholders interests, instead of giving priority to profit maximisation as in conventional insurance.

On the other hand the underwriting policy in an Islamic insurance company must comply with Shariah principles.

The main principles which govern the Islamic business model are:
- the basic principle is Shariah compliance;
- absolute submission to Allah for what is halal (lawful) and what is haram (unlawful);
- whatever is conducive to haram is not permissible. This is to block pretexts to haram;
- acts are judged by their intention, but good intention does not make the haram permissible;
- to come to an agreement based on haram does not qualify haram or remove the unlawfulness of this agreement;
- doubtful things are to be avoided;
- Harm must be eliminated but not by means of another harm;
- necessity dictates exceptions, but necessity has to be estimated by measure in accordance to circumstances.

Based on the above mentioned principles, the main guidelines of the underwriting policy of an Islamic insurance company can be summarized as followed.

- An Islamic insurance company may accept covering any risk except those which are related to Haram things or activities.
- The insurance company cannot accept any Haram. All the following are not allowed to be covered by an Islamic insurance company.
- Alcohol and drugs based products and activities.
- Prostitution.
- Haram: prohibited products.
- Any transaction involving Gharar, Riba, Maisir, fraud is strictly prohibited. The doubtful thing is a grey area upon which no consensus exists among Fiqh schools. Some doubtful things are ruled by Fiqh scholars to be prohibited but only abhorred by others or may even be permissible to others. In Islamic principles any doubtful thing or activity must be avoided.

Under necessity, some Haram things may be permissible but to a limited degree and only to the extent of meeting such necessity. For example trade in drugs is strictly prohibited in Islam but Muslims may trade in drugs for necessity (e.g. trading in drugs for medical purposes). In such cases, and subject to approval by Shariah Supervisory Board (SSB), the Islamic insurance company may accept covering this type of business.

All rating methods including actuarial and statistical techniques are available to Islamic insurance companies, as stated by AAOIFI standards:

'Contributions are estimated by the company's actuaries based on actuarial techniques and statistical methods relating to insurance operations, in addition to the international prevailing practices and the regulations issued by the company country of origin'.

In practice standard and worldwide wording have been used by Islamic insurance operators especially in property, engineering and marine insurance.

Model answer for Question 14

There are four different models in operation:

- Mudaraba model.
- Wakala model.
- Mudaraba-Wakala model.
- Pure co-operative model (non - profit).

Mudaraba model

- The insurance company is totally owned by the shareholders.
- Insurance funds (premiums) are provided by the participants who are considered as rabb-ul-mal in the Mudaraba contract.
- Shareholders manage the insurance funds and invest the surplus and they pay all management expenses from the shareholders funds or their share of the profit.
- All claims and technical reserves are paid out of the Mudaraba fund (premiums).
- In the case of any surplus being available after paying out all technical liabilities, it will be shared as per the agreement between shareholders and participants.
- In the case of any deficit the policyholders must bear the deficit and policyholders are obliged to pay additional premiums. Shareholders will only be liable in the case of negligence in managing the portfolio.
- Policyholders share in the profit (surplus) to be added to their account.

Wakala model

- Shareholders are the owners of the company as an organisation. They enter into a Wakala contract with policyholders to manage the insurance operations and receive in return a specified sum of money to be determined at the beginning of the underwriting year for managing the investment and insurance portfolio.
- Shareholders pay for all management expenses of the company at all levels out of its fees.
- Both the surplus and investment return are distributed by the company to the policyholders.
- Shareholders are entitled to a performance fee in case of achieving good results.

Mudaraba - Wakala model

Under this model an insurance company has to conduct two types of contracts with policy holders.

- Wakala contract: on a fee-driven basis to manage the insurance portfolio (underwriting, claims, reinsurance arrangements, etc). Under this contract the insurance company is entitled to get the fees regardless of the portfolio result. These fees will be taken out of the insurance fund (premiums or contributions).
- Mudaraba contract: on a profit-sharing basis to invest the policyholders' money. Under this contract the insurance company is entitled to get a profit-share (based on Mudaraba rules), out of the investment income.

Pure mutual model (non- profit)

The pure mutual model is a non-profit model such as government owned enterprises and a few companies. They employ a contribution method that is 100% Tabarru' (donation) from participants who willingly give to the less fortunate members of their community. In this case the insurance company is mutually owned by the policyholders themselves and there are no shareholders. The policyholders will appoint managers and employees to manage the portfolio on behalf of them in return for wages.

This is the purest mutual model which equates to the definition that the co-operative firm is owned and managed by the participants. This is in contrast to other models of Islamic insurance under which the insurance portfolio is owned by the participants while the insurance company is owned by shareholders.