Takaful articles

Number 18: September 2009

Roslinah Daud
Manager, Putrajaya Office
Takaful Ikhlas

UNDERWRITING FAMILY TAKAFUL SCHEMES

Introduction

In the academic world, many papers have been written about the concept of takaful in general, particularly comparing takaful to insurance schemes, presentation of various models used and the concept of risk management. Within the concept of family takaful too, a lot of emphasis have been put onto how to mitigate anti-selection risks presented by prospects to the takaful operator. As a result, stringent underwriting rules are normally imposed before a participant is admitted into a scheme. However, the concept of group family takaful brings about a different method of administration where little or no underwriting is done up to a certain amount of coverage called the Free Cover limit. Because of the lack of underwriting, many people think that Group family takaful presents a much greater risk to a takaful operator than individual schemes. Having said that, from Shariah point of view, is underwriting really necessary for a takaful operator or is there any other way to mitigate risk? This paper shall discuss about the concept of family takaful for both individual and group family and its underwriting aspects.

The concept of Family Takaful

Family takaful is a contract that protects individuals against financial losses resulting from death. Family takaful seeks to administer one form of uncertainty in our daily life called pure risk. Pure risk exists when there is no potential gain, only possibility of loss. In the case of Family Takaful, the possibility of loss from decease of a person apart from emotional loss is financial loss borne by the family of the deceased. The role of takaful operators is to share the risk with the participants in addition to allowing other members participating in the scheme to also share the risk and help ease the burden of the family as a result of the demise.

For family takaful, pure risk happens at the event of death and is certain. The only thing that is not certain is the time of occurrence of the death. However, the probability of death at certain age can be calculated from past experience. This probability of death, and several other assumptions such as the expenses incurred by takaful operator, the fee charged by takaful operator and profit margin, etc are being used to calculate the contribution that is required to be given by the participant. In other words, modern takaful practice is similar to insurance in practice whereby the contribution amount is calculated and is fixed for a standard normal person at certain age for a certain amount of benefit. This defies the actual concept of tabarru on the participant's part. Nevertheless, participating in family takaful schemes is a noble act due to this element of tabarru. Through participation in takaful schemes, participants are given the chance to help one another.

The Tabarru Fund

On the part of the takaful operator, the management of the fund should be done with utmost best practices with the intention of first, accumulating as much tabarru fund as possible to help those in need, and second to make as much investment income as possible for their clients. The two are inter-related. Why do they need to build the tabarru fund as quickly as possible? This is to enable them to first pay the claims should there be death or disability or any other covered mishaps occurring to their members. When a person passes away, the death benefit is paid from the risk fund or tabarru fund and if the contribution collected is more than the death benefit paid out as compensation, this is when the takaful operator will realize its underwriting surplus. Should there be an ideal scenario of no claims or less claims incurring, the fund is able to be invested and gain more surplus.

Under the mudarabah contract, this surplus is shared between takaful operator and the participants but there have been many arguments on whether the takaful operator can actually take their portion of this underwriting surplus. This is because the surplus actually belongs to the tabarru fund which by right, should belong to the participants. Even the sharing of surplus out of the tabarru fund with participants can be questioned, because once certain money is tabarru or given away, it should not be taken back or expected to be returned. This again defies the concept of takaful.

The same thing happens under the Wakalah contract. Although this surplus is not shared between takaful operator and participants, but because it is ploughed back into tabarru fund and investment account belonging to the participant, the practise is questionable.

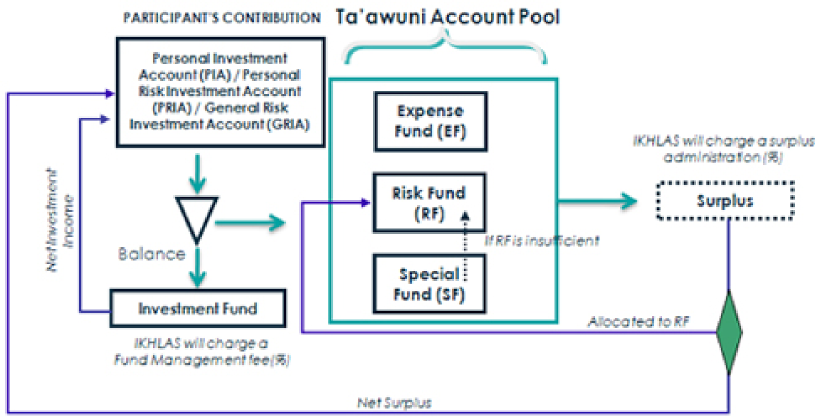
How do participants make money out of this venture?

First and foremost, when a participant enters into a takaful scheme, he is not supposed to have any intention of making money. His intention would be to share his wealth via contributing money or giving his money as tabarru towards a fund that is used to help another person in the event of needs. He should look beyond worldly rewards and be rest assured that when his time comes to face death, the takaful operator who manages the fund shall also ease the burden of his family as what it has done to ease the burden of others who have died earlier than him. Whatever rewards, whether out of investment or hibah given by the takaful operator is inconsequential and should be taken as bounty (rezki) from God.

However, in actual practice, that is not the case. When participants are coaxed by agents to participate in the scheme, they are usually promised a certain benefit amount and percentage of surplus as well as investment returns which is not really wrong as Islam encourages us to generate wealth as much as possible as long as they are acquired through lawful means and are spent in lawful ways. In other words, they must be halal and as long as they are used for good causes, involving as many members of the community as possible. But then again, the goal is really, to please God and achieve prosperity in this life and the hereafter. Hence, the participant must be aware of his intention when they participate in any takaful schemes.

From practical side, I make reference to the model used by Takaful Ikhlas to demonstrate how participants money is invested which enable the participant to accumulate his fund.

Takaful IKHLAS Model



Note: For GRIA, a portion of the contribution in the investment account is set aside for Tabarru' at the onset which will be dripped to the risk fund (RF). Any investment income derived from this amount in the investment account shall be allocated to the risk fund (RF). In this instance, IKHLAS will not charge a fund management fee (%). Net surplus distribution will be allocated and administered on an annual basis.

Referring to Wakalah model practised by Takaful Ikhlas, all contribution made by the participants go into a fund called the Investment Account and a portion of the contribution is dripped monthly into the Ta'awuni Account Pool which consist of 3 funds, the expense fund, the risk fund and the special contingency fund. The risk fund and the special fund are the tabarru funds. Hence, in essence, there are 2 types of pool funds being maintained under this Wakalah model: the investment accounts and the Ta'awuni Account and both accounts are invested to earn surplus. Out of the Ta'awuni Account, the surplus is ploughed back into the Investment Account and the Risk Fund at a pre-determined ratio. The surplus is not paid directly to the participants upon yearly declaration. Similarly, surplus out of the investment account is also given back to the Investment Account. In the model practised by Takaful Ikhlas, the Investment Accounts belong to participants and the company allows partial withdrawal of the account at certain period a participant wishes to withdraw. Only upon termination, i.e. terminal claim or surrender, will the Participant's Investment Account be refunded fully. So, what the participant gains out of this participation is the amount that is in his investment account plus surpluses. However, I feel comforted that this wakalah model practised by Takaful Ikhlas gives more advantage to participants because of the fact that first, the dripping the expense and tabarru' is not made one lump sum or annually but it is done monthly and this makes the investment fund belonging to the participant to be higher. And although, the practise of ploughing back surplus out of tabarru fund into the Investment Account is questionable, the act also makes the Investment Account grow faster which will benefit the participants.

How do takaful operators make money out of this venture?

Under the wakalah model, takaful operators earn their income through the management expenses charged and embedded in the contribution as well as the small fee (10% in the case of Takaful Ikhlas) charged out of the surplus arising out of investment from both Investment Accounts and Ta'awuni Account. That is why, takaful operators need to be wary of the costs incurred by the company so as not be overrun as it will affect the income earned by the Company. Takaful operators need to also be aware of the bottom line of each product as different products have different business assumptions factored in the contribution.

From Actuarial side, the assumptions used in product pricing would depend on type of benefits outgo which usually consist of expected claims to be paid which is assumed based on incidence rate such as mortality, morbidity, hospitalization, etc; expenses which include management expenses and commission to agents; and expected profit rate or investment rate and perhaps a small profit margin, although this is rarely done to avoid increase in rate. A takaful operator will make money if the assumptions are exceeded, meaning that if the actual incidence rate is good and below the rates assumed, expenses incurred are lesser than assumed and most importantly if the investment experience exceeds expectation.

Individual vs Group Takaful Schemes

Individual takaful schemes are schemes that are designed for individuals and the schemes are normally long-term in nature, consisting of savings element and protection in the event of misfortune or mishap. These products allow the participants to benefit from the profits of investment apart from benefiting from mutual assistance among its participants.

We know that among the defined benefits of family takaful is death and disability. Because of the nature of takaful, i.e. to manage pure risk (rather than speculative risk), there would be "opportunities" for sick people to join the scheme. What insurance companies or takaful operators do is to have the applicants undergo the process of underwriting to avoid this adverse selection. Hence the underwriting process will have the participants declaring their state of health including their height and weight and occupation as well as declaration regarding their medical history. While I understand the need for takaful operators to implement this process to protect the tabarru fund from depleting as a result of having to pay claims for such cases, again, I feel that takaful operators should not be overly concern about it. The underwriting process especially those involving medical underwriting with rigorous tests and detail analysis of the health condition of a person does not conform to the spirit of ta'awun or mutual co-operation. Takaful operators should not decline any person from wanting to tabarru to the fund to help other people but instead should provide a control in the amount of coverage in the initial years of the coverage. For example, imposing conditions to the payment of benefits such as lien should the sick person die in the first 3 years or refund of full contribution if it happens in the first year or something to that effect but a proper explanation as well as offer and acceptance must be given in order for the contract to be valid.

In contrast, the concept of group is implemented when the takaful scheme is offered to a group of people who have a business and professional relationship to the contract owner and are provided coverage under a single contract. In comparison with individual takaful schemes, several distinguished features are evident in group takaful. Some examples are the substitution of group underwriting for individual underwriting, the use of a master contract, lower administrative cost and flexibility in contract design.

Group schemes can be divided into compulsory or voluntary schemes. Compulsory schemes are schemes of which the participation is made mandatory by the Certificate Owner of Grantee. Voluntary schemes, on the other hand, are schemes of which the participants are given the choice on whether to participate and is similar to individual schemes. From an underwriting point of view, voluntary schemes, whether contributory or non-contributory are usually subject to a high probability of anti-selection, and most companies would implement similar underwriting rules to individual schemes.

Individual vs Group Underwriting

Under individual schemes, individual participant's health and financial background is assessed especially for a large sum covered. If an applicant is found to display any signs of health impairment, further questionnaires or medical reports are required to be submitted. The reports will then be assessed and the decision is normally to accept as standard, load with extra mortality, postpone or decline.

In group cases, no individual evidence of insurability (i.e. health declaration or evidence) is requested for benefits within the amount of "Free Cover Limit". Free Cover Limit is usually granted for a group of more than 10 lives and is calculated based on the number of members in the group and the average sum covered of the group even though the benefit for an individual can be substantial. The general rule is that if a Free Cover Limit is granted to a group, there shall be no underwriting for individual members whose sum covered are within the Free Cover Limit.

This is because group underwriting is normally not concerned with the health aspect or other insurability aspects of any particular individual. Instead, it aims to obtain a group of individual lives that will yield a predictable rate of incidence such as mortality or morbidity. If a reasonably sufficient number of groups of lives is obtained and if these groups are reasonably homogeneous in nature, then the mortality or morbidity rate will be predictable. The group becomes the unit of underwriting, and whatever rules applied to individual will also apply to this group as a whole.

The nature of group takaful schemes which lacks medical underwriting makes the scheme to be more risky to takaful operators. For group takaful schemes, initial underwriting of the group is made by marketers (who are equally eager to bring in production). These marketers must be able to exercise balance between achieving production targets and protecting the company's interest. Hence, in underwriting group schemes, certain important features should be present that either are inherent in the nature of the group itself, or may be applied in a positive way to avoid serious adverse selection and group marketers must be aware of these features which are:

a. The coverage must be incidental to the group, i.e. the members of the group must have got together for some purpose other than to obtain takaful coverage.

b. There should be a steady flow of persons through the group, i.e. there must be an influx of new young lives into the group and a flow out of the group of the older and impaired lives. With groups of "actively at work" employees, it may be assumed that they are in average health as "actively at work" is defined as a participant that is currently engaged full time with regular salary and physically present during working hours except if he is on study, training or normal holidays plus he has not been hospitalised more than 21 days in the last 12 months.

c. There should be automatic determination of benefits. Group underwriting requirements commonly insist on an automatic basis for determining the amount of benefits on individual lives, beyond the control of the employer or employees, otherwise there would be anti-selection, in that the older or poorer health employees may opt for higher coverage. The coverage must be based on some eligibility factor.

d. There should be minimum participation by the group. A substantial number of eligible members must be present to be covered by the scheme. In contributory plans, at least 75 percent of the eligible employees should join the plan for a coverage to be effective and in non-contributory plans, 100% participation is required. Contributory schemes are schemes of which the contribution or partial contribution is made by the participants as compared to non-contributory schemes of which the contribution is made 100% by the Certificate Holder or Grantee. This is likened to economies of scale where by covering a large proportion of a given group, the insurance company gains a safeguard against an undue proportion of substandard lives.

Use of a Master Contract

In Individual Schemes, certificate contracts are given to each individual as the contract holder but under group schemes, the aqad is signed between the employer or grantee who acts as a single organization on behalf of the group. Hence, a single master contract is issued to this grantee as evidence of takaful coverage, and this master contract spells out the contractual relationship between the group contract owner and the takaful operator.

Lower Administrative Cost

This results in lower administrative costs as less paperwork is necessary. The nature of the group approach permits the use of mass-distribution and mass-administration methods that allows economies of operation that are not available in individual takaful schemes. In addition, the commission payable to agents are much smaller (10%) as compared to individual schemes. The administration is much simplified as there is only one party to deal with, i,e. the master contract holder, cost of medical is reduced as sum covered below the Free Cover Limit is covered without health evidence.

Flexibility in contract design

As compared to individual schemes where the benefits are normally fixed, the benefits for group schemes can be tailor made to suit the needs of the contract owner. The rates charged would depend on the weighted average age of members of the group, the eligibility and the types of coverage necessary. Most group schemes are part of employee benefit program and the contracts can be written to meet the objectives of the contract owner as long as it does not allow adverse selection, complicated administrative procedures or violation of legal requirements.

Conclusion

Underwriting is a concept brought over from conventional insurance to mitigate risk of adverse selection. Although the concept generally is acceptable to protect the interest of other participants as well as to ensure that the funds managed by takaful operators are not depleted to pay claims as a result of adverse selection, too much underwriting, especially in individual family takaful does not support the concept of takaful of helping one another in need. In fact, it may be construed as stopping prospects from contributing to tabarru and doing good deeds. Takaful operators should be willing to be creative and come up with other ways to mitigate adverse selection risk such as applying lien or a refund of contribution if a claim happens within a certain period from inception.

For group products, because of the large sum covered and the way group products are administered, underwriting is necessary to be implemented for cases above the Free Cover Limit to mitigate anti-selection risks and in order to protect the funds from depleting. Since group products are often taken up by the contract owner (and not the individuals) as part of an employee benefit scheme, the element of intention to tabarru may not be as strong as individual family products taken by individuals. Actually, for group family, there exists a clause called pre-existing clause in the group master contract which may help mitigate risks to the takaful operator. The only problem is that the clause has not been strictly observed by most takaful operators. This is because not many takaful operators are aware that Free Cover Limit exists to assist in the administration of the group products (due to the volume of data involved) and the pre-existing clause exists to protect the takaful operator of anti-selection for cases below the Free Cover Limit. They think that all sums covered below the Free Cover Limit has to be paid out, resulting in a high claims ratio in the product, and the takaful operators implementing more stringent underwriting rules.

In the spirit of ta'awun or mutual co-operation, underwriting is an issue that needs to be looked at by takaful operators. After all, "Al Ghorm bil Ghonm" or "No Pain No Gain" is a concept often associated with risks management and profit making and therefore the maxim should also be upheld by takaful operators.

If you would like more information on ICMIF and its services to the takaful sector, please contact Sabbir Patel (*sabbir@icmif.org*), or visit *www.takaful.coop*.