Investment of Islamic Insurance & Reinsurance Companies Funds

Prepared By

Salah El Din Musa Mohamed Sulieman

July 2016 – Khartoum

Contents

Foreword

Despite the passage of almost four decades of continuous success of the Islamic Insurance Industry characterized by robust performance and high growth rates that outperformed its conventional counterpart, there is still a lot of misunderstanding and misconceptions relating to this relatively new industry which needs to be examined and elaborated to provide for more clarification and a better understanding of this industry.

In pursuance to achieve one of its main objectives to promote and develop Islamic Insurance, The International Federation of Takaful and Islamic Insurance Companies – IFTI (headquartered in Khartoum, Sudan) have invited me to prepare a paper on the issue of investment in Islamic insurance and reinsurance companies to be discussed in a workshop that will be organized by IFTI on the 20th of July in Khartoum, Sudan along with the issues of capital and zakat.

This is an endeavour to put my insights and practical experience in a concise and simple manner that can be easily understood and digested.

I trust that the paper is up to the expectations of the organizers and has touched on the main aspects of investment in the Islamic insurance undertakings and hope that what was outlined in the paper will open the flour for fruitful discussion and positive contributions from the participants in the workshop that will help in developing a robust and sustainable Islamic insurance industry.

Salah El Din Musa Mohamed Sulieman
Deputy Chairman
The International Federation of Takaful and Islamic Insurance Companies
July 2016, Khartoum, Sudan

Introduction

The nature of insurance and reinsurance business allows insurers and reinsurers to have substantial funds that can be invested to earn profit and capital gain.

When investing these funds, Islamic insurance undertakings should fully adhere to the following;

- **Complete differentiation and segregation between the Shareholders' funds investment portfolio and the Policyholders' funds investment portfolio.**
- **Complete differentiation and segregation between general insurance funds investment portfolio and takaful (life) funds investment portfolio.**
- **All investments must be in Sharia' compliant venues and instruments as mandated and approved by the Sharia' Supervisory Board.**

The Importance of Investment

Investment is the other face of the coin in insurance business as investment returns on Shareholders' Funds and Policyholders' Funds are of vital importance to insurers and reinsurers that enable them to make profits and surplus.

The overall objective of investment in insurance and reinsurance undertakings is to enable them to strengthen their financial positions and to meet their liabilities to their policyholders when they fall due. Therefore, careful and prudential investment strategies and policies are crucial to realize the highest possible returns without being exposed to high risks.

Sources of Funds Available for Investment

As mentioned earlier, insurers and reinsurers hold substantial funds at their disposal which can be invested. These funds are essential for insurance and reinsurance operations. In Islamic insurance undertakings, these funds are divided into two parts;

1. **Shareholders' Funds which are mainly composed of the paid up capital and the statutory reserve and are not tied to any liabilities to the policyholders but still a minimum capital should be maintained as mandated by the prevailing Regulatory Frameworks to fulfill the solvency requirements and to provide for Qard Hassan in case of any deficit in the Policyholders' Funds as per Islamic insurance principles and practice.**
2. **Policyholders' Funds which are composed of technical reserves and accumulated retained surplus. These reserves are**

necessary to cover the outstanding liabilities to the policyholders and can be summarized in the following;

a. Unearned Contributions Reserve

In general insurance policies under most classes of insurance are usually taken for a period of one year. This means that a policy issued on the 1st of February this year, for example, will continue to run till the end of January of next year. Therefore, a portion of the contribution must be set aside at the of this accounting year as a reserve to cover the risk of a claim being made in the remaining period of the policy that falls in the next accounting year.

The way of how calculating this reserve differs according to the class of insurance

and the Regulatory Frameworks.

b. **Unexpired Risks Reserve**

This reserve is allocated as a top-up for the unearned contributions reserve to cater for unexpected circumstances that may result in the insufficiency of the unearned contributions reserve to meet liabilities left over from the previous year.

c. **Outstanding Claims Reserve**

This reserve is created out of the current year's contributions to provide for claims registered during the year but not settled till the end of the year.

d. **IBNR Reserve**

The Incurred But Not Reported reserve is allocated to provide for losses that have happened but not reported to the company by the end of the year.

This reserve is similar to the outstanding claims reserve except in that it provides for liabilities unknown at present to the company and usually calculated based on past years experience.

e. Other Reserves

Other reserves such as Contingency Reserve, Catastrophe Reserve …etc may be allocated as required or mandated by the Regulators.

f. Mathematical Reserve

This reserve is maintained under life insurance business (takaful) and particularly important for long-term and saving-investment based policies and calculated by actuaries as mandated by Regulations.

g. Accumulated Retained Surplus

Surplus is one of the main features of Islamic insurance which is based on

the principles of cooperative insurance. Surplus is the financial amount that remains in the Policyholders' Fund from contributions and policyholders' investment returns after deducting claims, technical reserves and management expenses.

Decisions on how much of the surplus is to be distributed to the policyholders and how much is to be retained in the Policyholders' Fund rest with the Board of Directors and the Sharia' Supervisory Board and the approval of the Policyholders General Assembly as in some Regulatory Frameworks.

The accumulated retained surplus represents an additional excess capital whish belongs to the policyholders that augments the financial position of the Policyholders' Fund and provides a cushion to protect against unexpected claims and to make good

any deficit in the Policyholders' Fund instead of resorting to the Shareholders' Fund for Qard Hassan. Accumulated retained surplus avails the Islamic insurance undertakings with substantial funds for investment and varies from one company to another and from one year to another due to a number of factors which include;

- Volume of business

- Pricing

- Claims experience

- Management expenses

- Regulatory and Sharia' constraints and

- The prevailing investment market conditions

Investment Management

In view of the vital importance of investment returns to insurance and reinsurance undertakings to protect the value of their funds and to meet their liabilities to their policyholders, they pay very much attention to how they manage their investment assets.

Most Regulatory Frameworks lay down the rules for investment practices and management of the investments of insurance undertakings. Many regulations mandate the establishment of an Investment Committee composed of at least two members from the Board of Directors authorized to decide on investment strategies and policies and investment assets allocation.

The Investment Committee may in turn establish an independent competent Investment Department under its direct supervision to implement its investment strategies and policies and its decisions on investment assets allocation.

In addition to the mandate of the Investment Committee and its composition, some Regulations also determine on how it is to be remunerated and from which fund.

Investment Strategies and Policies

Determined by a number of factors including Regulatory Frameworks, Sharia' compliance, tax and the prevailing economic and political conditions, investment strategies and policies and decisions on investment assets allocation vary widely from one market to another.

The composition of the investment portfolio is also affected by the product mix of each company which is differentiated and segregated between general insurance and life (takaful) insurance business.

Investment of insurance undertakings' funds is also affected by fluctuations in claims payment, therefore, decisions on allocation of these funds should strike a balance between security, liquidity and good returns by allocating these funds to types of investment that carry low risk and can easily be sold at short notice to cover unexpected large claims and at the time produce satisfactory returns.

Based on the above mentioned factors, investments assets are mainly invested in bank deposits in some markets while concentrated in equities (stocks and shares) in other markets and dominated by Sukuk and government bonds and real estate (land and buildings) in some other markets.

In some markets the composition of the investment portfolio, particularly the policyholders' investment portfolio, is determined by the Regulators to ensure well management of the funds so as to protect the interest of the policyholders.

Investment New Trends and Statistics

Traditionally the core business of the insurance industry is risk mitigation through offering quality and reliable insurance solutions.

In recent years the insurance industry has received well recognition by the international community of the crucial role that it can play in the socio-economic development and the stability and wellbeing of the global economy.

The changing risk landscape has led the insurance industry to develop resilient strategies to address the increasing environmental, social and governance (ESG) risks that face our world of today through holistic and far-sighted risk management and assessment and investment strategies in which ESG issues are considered.

Developed by the UN Environment Programme's Initiative, the launch of the Principles for Sustainable Insurance represented a framework for the global insurance industry to address environment, social and governance risks.

Thousands of companies have embraced and implemented the United Nations Global Combat and the Principles for Responsible Investment by integrating ESG issues into investment decision-making.

Obtaining its funds from its shareholders and policyholders, the insurance industry is one of the world's major institutional investors supplying long-term capital for governments and industry.

With more than USD 30 trillion to invest, the insurance industry represents one third of the world's investment capital out of which only USD 42 billion was spent on smart-risk-investment.

Smart-risk-investment is a terminology that has been formulated by experts from the insurance and sustainable investment sectors to refer to climate-smart-investment.

Other terms such as community investing, ethical investing, social responsible investing, green investing, among many others are also used to refer to the same concept.

The International Cooperative and Mutual Insurance Federation (ICMIF) and the International Insurance Society (IIS) pledged in the United Nations Climate Summit in New York, September 2014 to increase the insurance industry investments in smart-risk-investments by 10 fold to reach USD 420 billion by 2020.

It is worth mentioning that the cooperative and mutual insurance sector, the fastest growing part of the insurance industry, accounted for 27% of the global insurance industry and invested combined assets of USD 8 trillion in 2013.

Concluding Remarks

By virtue of its nature, the Islamic insurance industry, based on the principles of cooperative insurance as long-term and values-based insurance, is very capable to offer long-term insurance solutions and financial and investment flows t o address the economic and social challenges faced by the people around the globe.

Despite the impressive double digit growth achieved annually by this industry, but its size compared to the global insurance industry, is still very small. However, there is a big room for the Islamic insurance industry to expand and play an important role in the local, regional and the international investment market, particularly the smart-risk-investments and sustainable development in general.