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**FINANCIAL AND ECONOMIC TURMOIL:
OPPORTUNITIES FOR RE(TAKAFUL) AS A
VIABLE ALTERNATIVE**

By

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AGENDA

- Introduction
- Lessons Learned
- Underlying Principles of Islamic Finance
- Takaful and Retakaful Principles
- Opportunities for Takaful and Retakaful
- Conclusion

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INTRODUCTION

- It is exactly a decade after the East-Asian Financial crisis of 1997-98 that the world is saddled with yet a much bigger and deeper financial and economic turmoil.
- The east-Asian Financial crisis was mainly due to the serious structural weaknesses of the East Asian economies where rapid economic growth for over seven years was not supported by genuine growth engine.

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Introduction

- Rather it was fueled by rapid monetary growth, current account deficits, negative Savings-Investment gaps and short term capital inflows.
- The vulnerability was further enhanced by overvalued exchange rate and reduction in foreign capital inflow.

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Introduction

- The current turmoil which became apparent in 2007 was triggered by a dramatic rise in mortgage delinquencies and foreclosures in the United States, causing major adverse consequences for banks and financial markets around the world.
- The crisis has exposed pervasive weaknesses in financial industry regulation and the global financial system.

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Introduction

- Almost no one is spared by this crisis which is recognized as the biggest the world has ever faced.
- Close to 80% of U.S. mortgages issued to subprime borrowers prior to 2006-07 were adjustable-rate mortgages.
- The subprime borrowers were convinced that the house prices would not decline. However, this assumption was not true.

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Introduction

- By 2006-07, when U.S. house prices began to fall, efforts to refinance failed and the adjustable-rate mortgages began to reset at higher rates, pushing mortgage delinquencies higher.
- Securities backed by subprime mortgages which were widely held by financial firms, lost most of their value.
- The result has been a large decline in the capital of many banks and U.S. government sponsored enterprises, tightening credit around the world.

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Introduction

- Some of the strongest financial institutions suddenly had to be bailed out or went into bankruptcy.
- Even sovereign funds of certain countries which were accumulated by the petro-dollars experienced very heavy losses.
- This is recognized as the worst economic and financial crisis the world has ever experienced.

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Lessons Learned

- The first lesson learned is that even real estate has down side.
- House prices cannot continuously increase.
- There are cycles which will affect the value of real estate.
- Secondly, the risk associated with subprime mortgages can be extremely high when it coincides with down side of the real estate value.

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Lessons Learned

- Thirdly, there is another major risk pertaining to the adjustable-rate mortgages that were offered to the subprime borrowers.
- When the value of their properties declined, these adjustable-rates were reset at higher market prices, making refinancing of the loans more difficult.
- Hence the dramatic rise in the delinquencies or bad loans.

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Lessons Learned

- Fourthly, when mortgage delinquencies rose, the loans were converted to derivatives that surely had no strong underlying collateral. It is these derivatives that were sold to various funds including sovereign funds of some of the richer countries.
- Fifthly, which is the most important factor of all, is the greed that has been demonstrated by various parties in the process.

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Lessons Learned

- Finally, we observe the weakness of the interest-based financial system that could not take care of the risk that have been shifted from one sector of the financial system to another.
- The overall effect is a worldwide recession that spared virtually no one at all.

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Lessons Learned

- We have heard voices airing opposition to the current financial system that is based on interest. Some even go a step forward to recommend that we take a close look at the Islamic system. What is it that Islam offers then?

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Underlying Principles of Islamic Finance

- Islamic finance is based on the Islamic world view whose fundamental values dictate all aspects of a Muslim's life.
- The basic values are not only divine but universal.
- Their aim is to guide man to create a very balanced and just world.
- These are unity, trust, property rights, justice, co-operation and risk sharing.
- These values become the parameters within which a Muslim should operate in this world so as to be rewarded commensurate with his deeds in the hereafter.

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Underlying Principles of Islamic Finance

- The concept of unity emanates from the oneness of God.
- It is not only the most fundamental principle but it also embraces all other values into a very coherent and integrated manner.
- It can be viewed as the very basis of the Islamic faith and at the same time it acts as the integrator of all other values.
- Literally it signifies a unique relationship with the Only One that excludes all similar relationships with anyone else

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Underlying Principles of Islamic Finance

- Its uniqueness negates the remotest possibility of admitting the existence of another being worthy of worship.
- This implies that Unity presupposes a consciousness which brings a sense of equality among all men.
- The moment one feels inferior to another being, his freedom and independence is adversely affected.

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Underlying Principles of Islamic Finance

- Similar is the case when one upholds the opinions of others without question, simply because such opinions belong to someone who is acknowledged for his status, power, wealth or colour of skin, etc. these cases run counter to the very spirit of independence and equality.
- Mughirah bin Shu'bah's description of Islam to the Persian general, Rostam, clearly exhibited this independence. He explained, "... and to emancipate people from its obedience of men to the obedience of Allah".

Underlying Principles of Islamic Finance

- The second Muslim emissary to the same court of Rustam, Rabi' bin 'Amir, repeated the same description of Islam thus: “Allah has sent us forward so that we may liberate whomsoever He wills, from following men to the obedience of Allah and pull them out of their narrow world into the broader one, and from under the suppression of various religions into the justice of Islam”

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Underlying Principles of Islamic Finance

- Yet another aspect of Unity concerns man's particular relationship with the universe. The universe is undoubtedly created for man's use and not to be feared or revered. The way he handles or uses the world of nature around him has to be dictated by Unity. This is necessary because the revealed Will of Allah provides him with a vision of a society endowed with a system of values, healthy, well-provisioned, good life in cooperation with fellow men.

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Underlying Principles of Islamic Finance

- It is only under the direction of Unity that man would not create mischief on this earth. Instead, this vision would inspire man to change the world around him according Allah's Will. This is the real mission of a Muslim. This mission is to be undertaken with full commitment to Allah.
- As alluded above, we can clearly see the framework within which the concept of Unity creates for man to conduct himself in all aspects of his life.

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Underlying Principles of Islamic Finance

- The second value that directly emanates from the first is man's role as the vicegerent or the trustee of this world. As a vicegerent he has the responsibility of utilizing the resources that have been made available to him. Whilst he is given the freedom to use the resources, he should realize that he is not the absolute owner but only allowed to use them. For as long as he has lawfully earned and accumulated the wealth he can lay claim to its ownership. However, this ownership is only temporary.

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Underlying Principles of Islamic Finance

- He should not devour other peoples' property by the wrong means. Hence he has to be responsible and will be accountable for all the wealth that he has accumulated and utilized. He should not be wasteful, neither should he be stingy. He should use them in moderation. The whole objective of utilizing the resources is to create benefits to mankind and to avoid mischief and harm, in line with the overall objectives of the Shariah. Hence, hoarding is not permitted because it will only take the wealth away from circulation in the economy. Hoarding will only stifle economic growth. This role of the vicegerent in fact has defined his property rights.

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Underlying Principles of Islamic Finance

- The second important aspect of trust that man should fulfill is the requirement of keeping all promises or contracts.
- Any promise whether verbal or written has to be fulfilled.
- When a promise or contract is not fulfilled, it is a breach of trust.
- Indeed the Quran is very clearly against those who say something but do not follow it up with action.
- What more when one promises to do something and yet does not deliver.

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Underlying Principles of Islamic Finance

- These are the basis by which one is trusted or considered to be reliable.
- When we break promises it is tantamount to lying.
- Telling a lie is also considered to be one of the gravest sins.

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Underlying Principles of Islamic Finance

- If Unity defines the framework within which man conducts his life, justice, which is the third important value in Islamic Finance, is the measure or the benchmark by which he should conduct himself.
- In other words, justice is the most important ingredient for healthy, harmonious, peaceful and satisfying relationships.
- Literally justice is to put things in its proper places.
- This applies to man, power, responsibility, wealth, individual and societal rights, etc.

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Underlying Principles of Islamic Finance

- It is not justice to put someone in a position of responsibility when he has no ability to perform the required tasks. Similarly to distribute wealth to those who do not deserve is not justice at all.
- Justice itself is an absolute and not a relative concept.
- There is no such thing as more or less just. It is either just or unjust.
- There is nothing in between. In other words, we cannot have the slightest element of injustice in all our dealings.
- Even if the amount of injustice is very minimal or small, the whole deal is considered unjust.

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Underlying Principles of Islamic Finance

- A good example in Islamic Finance is the case of transactions with ambiguity or “*gharar*”.
- *Gharar* is prohibited because it is one of the two causes for invalidity of a transaction.
- A transaction that contains any degree of *gharar* will not be valid because it can incur injustice to any party involved in the transaction.
- Justice is not only for one particular party but for all parties involved.

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Underlying Principles of Islamic Finance

- Another example in Islamic Finance is *riba*.
- *Riba* is the second factor that invalidates transactions.
- Again the main reason for its prohibition is the injustice that it can inflict on one of the two parties involved.
- The injustice can be on the part of the borrower or the lender.
- The borrower will have to bear all risks and yet he is not compensated.

Underlying Principles of Islamic Finance

- The lender on the other hand may be faced with delinquent loans and not able to get what he lent.
- Rather than allowing it only for those cases that are considered as fair or with mutual consent, Islam prohibits it entirely.
- This is the approach Islam takes to eliminate all possible avenues to injustices.

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Underlying Principles of Islamic Finance

- The fourth principle is co-operation.
- Co-operation can only come about when we are readily prepared to help one another in goodness and with God-consciousness.
- We do not co-operate in harmful or non-beneficial acts.
- Such actions will be against the objective of Shariah itself and will not be good for ourselves nor for society.
- Willingness to co-operate will encourage society to conduct profit and loss sharing, joint-venture or other modes of sharing or partnership.

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Underlying Principles of Islamic Finance

- It is through the spirit of co-operation that we can hope to have individuals with capital to join hands with those with expertise to conduct some income generating activities that would benefit both.
- Similarly, those in need of huge funds or capital to purchase a piece of property could get the capital or wealth that he needs to purchase what he desires with a promise to pay back.
- Indeed the spirit of co-operation is the basis for the willingness to share risks.
- We do not shift risk from one sector to another of the economy or from one individual to another.

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Underlying Principles of Islamic Finance

- This is why lending capital to others is only to help and hence no return is to be reaped in the process.
- Whatever we give in the form of lending, we can only receive the same amount with no increase.
- Lending on interest is basically shifting the risk from the lender to the borrower.
- This is prohibited because it creates unnecessary burden to the borrower.
- The prohibition of interest immediately gives rise to various modes of transactions and capital allocations.

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Implications To Islamic Finance Practice

- Baaed on the Islamic world view and the values of unity, trust, property rights, justice, co-operation and risk sharing described above, we could discern the following features of Islamic fincance in practice.
- The prohibiion of interest in particular has given rise to instruments such as profit and loss sharing, partnership, buying and selling with cost plus, leasing, etc.
- All these instruments can only be structured when backed by assets.

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Implications To Islamic Finance Practice

- The main strength of Islamic Finance is the asset backed structures that it has to adhere to which tremendously reduces financial risks.
- It is also closely linked to the real sector which provides balance between the financial and the real sector.
- Such a balanced economy will surely be healthier and stronger with inflation under control and real growth is attained.

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Implications To Islamic Finance Practice

- Prohibition of *gharar* or ambiguity will not allow excessive speculation, hoarding, or investments in multi-level derivatives that had brought down the current global economy.
- Moderation, co-operation, property rights again play important roles in self regulation which would reduce the heat and greed in the economy.

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Takaful and Retakaful Principles

- Takaful comes from kafala in Arabic which means guarantee.
- It is not the guarantee of capital or assets from financial losses but rather the sanctity of life, safety of wealth and property which has its roots in the history of tribal life in Arabia.
- Tribal wars were common which normally takes a long time to settle, mainly because the revenge is not only on the killer but on any member of the tribe.

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Takaful and Retakaful Principles

- It is not sufficient to protect only the killer but the whole tribe of the killer.
- This practice is being applied to the modern concept of takaful wherein the guarantee is on all individuals facing the same risk.
- This concept of risk sharing or spreading of risk does not entail a sale and purchase contract as in the case of conventional insurance.

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Takaful and Retakaful Principles

- Takaful or insurance has two main functions, the protection against risks as well as investments.
- Whilst the protection against risks is accomplished by the risk sharing concept, whereas the investments have to abide by the Islamic Finance concept which must be asset backed.

Takaful and Retakaful Opportunities

- There are at least four reasons to support this possibility.
- First, the credit crunch that is caused by the turmoil requires alternative ways to increase spending for the generation of economic growth.
- Governments may have to invite active participation by members of society to undertake economic activities which will reduce substantial financial pressure on governments.
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Takaful and Retakaful Opportunities

- Takaful and retakaful will have tremendous underwriting opportunities if governments decide to move forward in this Shariah compliant manner.
- Indeed risk premium for governments being generally lower would make it more profitable for takaful and retakaful operations.
- Secondly, one of the problems related to the current global turmoil is the shifting of risks from one sector to another.

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Takaful and Retakaful Opportunities

- Conceptually takaful and retakaful operates on the basis of risk sharing and not risk shifting.
- Hence it should be preferred to any other alternative.
- Thirdly, opinions are rife that the failure of interest based system is imminent.
- More and more of the financial instruments are being structured in Shariah-compliant manner characterized by asset-backed or fully collateralized.

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Takaful and Retakaful Opportunities

- Such structures will again attract takaful and retakaful to ensure the whole chain is Shariah-compliant.
- Fourthly, there have been tremendous property construction activities which were started before the advent of the crisis.
- These construction activities almost surely have to continue in order to avoid further losses.
- Again takaful and retakaful would be the way to go in such a huge construction activity.

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Conclusion

- The main strength in takaful and retakaful is the risk sharing concept that provides an efficient and fair means of guaranteeing the safety of individuals and their properties.
- Secondly the investment behaviour of takaful and retakaful companies have to be in line with Shariah that encourages balance between the financial and real sectors and hence reduce inflation and further mitigates risks of financial losses.

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Thank you

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