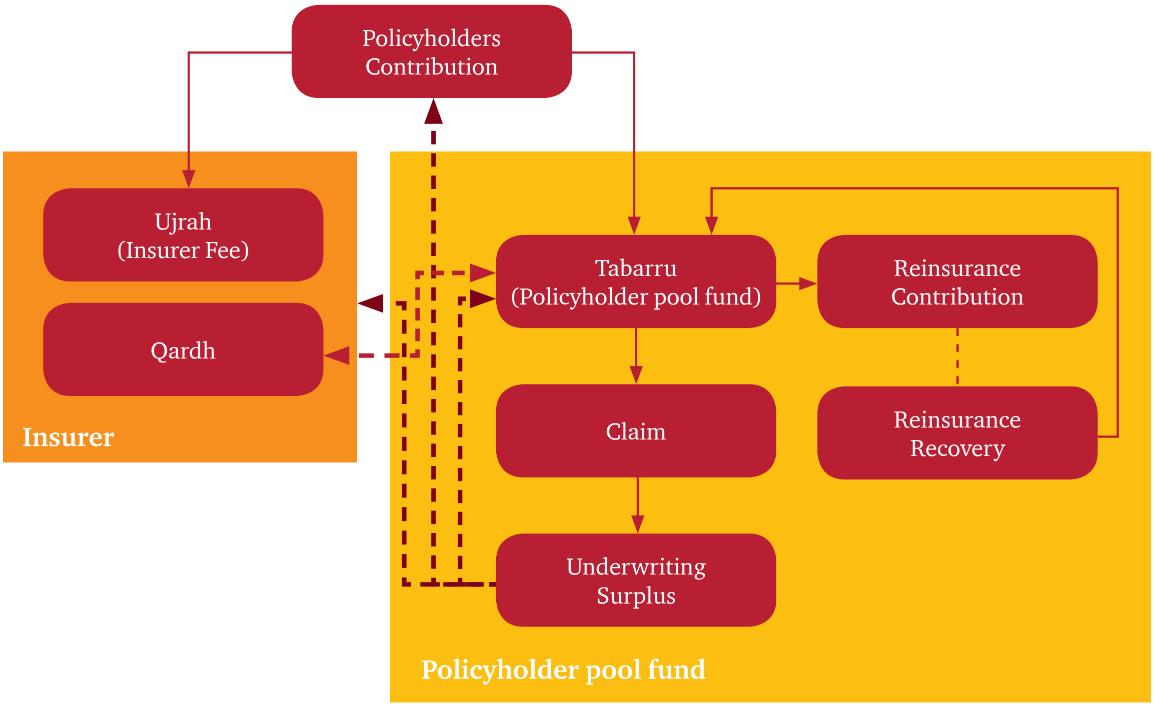
August 2017

# *Sharia Insurance Reserving*

## Background

Conventional insurance is a risk transfer contract from the policyholder to the insurer for an exchange of premium. Under conventional insurance, premium will be recognised as an income while claim payment will be recognised as a cost for the insurer. This contract would not comply with the Sharia law due to uncertainty (*gharar*) of the value of payment under specified transfered risk in the future. *Takaful* ("Sharia Insurance") is an Islamic alternative to conventional insurance which uses the concept of 'donations' from a group of policyholders to a risk pool fund (*Tabarru*) to share their risk. As the operator who manages the risk pool fund, the insurer will receive a fee or *ujrah* (under *wakalah* contract), and/or a profit-sharing contract (under *mudarabah* contract).

In a typical *wakalah* contract, a portion of the premium ("contribution") will be used as *ujrah* which is the fee for the insurer while the rest will be accumulated into the *Tabarru* fund. From the insurer point of view, *ujrah* is allocated to their expenses, commission and profit. Benefit-related payment to the policyholder will be deducted from the *Tabarru* fund which are separated from the insurer liability. Therefore, there is no direct insurance risk for the insurer as long as the *Tabarru* fund is sufficient to pay the benefits to the policyholders. It is stated in the regulation that if the *Tabarru* fund is not sufficient to pay the policyholder's benefit, the insurer must provide a loan to the *Tabarru* fund without interest (*qardh*).

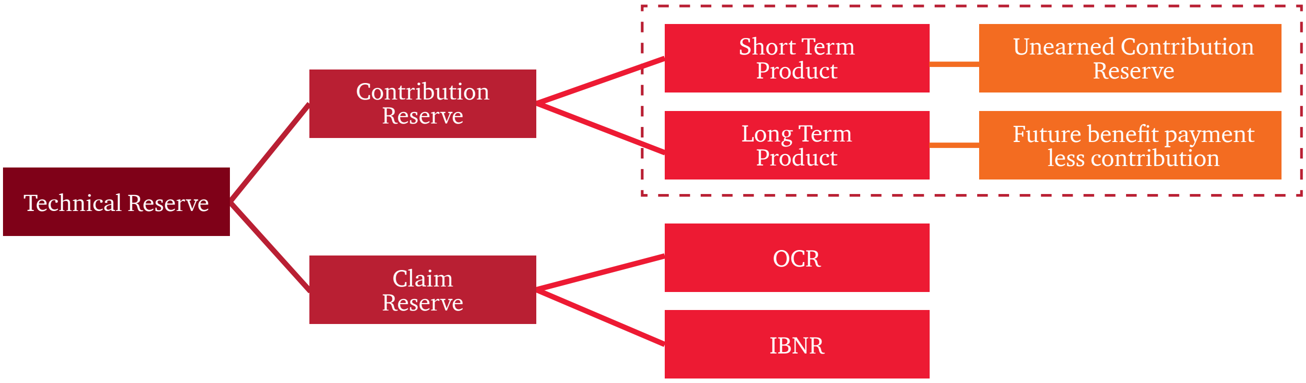



As the policyholder's benefit payment will be taken from the *Tabarru* fund, the insurer need to set an insurance reserve on the *Tabarru* fund, allowing for expected future benefit payment. The insurer also must maintain the solvency level of the *Tabarru* fund. From the regulatory side, it was not clearly stated to specifically form a reserve for the *ujrah* side. There were also a different understanding in the industry, where some insurers only book reserve on the *Tabarru* fund without any reserve on their maintenance expenses. The impact of this practise on reserve booked for sharia products is not comparable with conventional ones.

The conventional insurance business is shifting to the framework consistent with IFRS where shariah insurance is not covered. It is an issue as broadly the coverage and risk are the same. Indonesia has PSAK 108 as an accounting standard for sharia insurance transaction since 2009. In 2016, *Dewan Standar Akuntansi Syariah* published an updated PSAK 108 complete with updated reserve framework for sharia insurance. In the same year, Indonesia Financial Services Authority (OJK) has launched a new regulation about sharia insurer financial health requirement which includes the reserving requirement and framework for sharia products.

## Updated PSAK 108

The updated PSAK 108 which covers sharia insurance accounting standard made some changes on the reserving framework with more aligned regulatory requirement. PSAK 108 requires insurer to book reserve and classify the product based on the coverage period and the contract renewability.



*Ujrah* as part of the income for the insurer and the acquisition cost as part of the insurer's liability are recognised on a straight line basis over the coverage period. *Ujrah* and the acquisition cost are part of the insurer income and liabilities which are related in managing the *Tabarru* fund. The insurer also must perform a liability adequacy test on their reserve with updated best estimate assumptions.

PSAK 108 also states that the *Tabarru* fund and the policyholder investment fund are shown separately from the insurer's liabilities and equity.

## Change in regulatory requirement –28/SEOJK.05/2017

As we mention before in the previous section, some insurers only booked reserve on the *Tabarru* fund. The impact of this practise on the reserve booked for sharia products will be their comparability with conventional products. For example, suppose there is a traditional product with yearly renewable term which the contribution reserve is using unearned contribution reserve. Compared to the conventional product reserving which are based on gross premium or sometimes gross premium after direct cost, we can see that the reserve amount for the sharia product could be less than the conventional product subject to identical premium and benefit.

| Reserves | Sharia | Conventional |
|---|---|---|
| **Premium reserves** | | |
| Products with coverage of one year or more and renewable (short-term product) | Maximum of daily unearned *Tabarru* contribution reserve and unexpired risk reserve<br><br>Plus<br><br>Unearned *Ujrah* excluding direct commission | Maximum of daily unearned premium reserve and unexpired risk reserve |
| Products with coverage more than one year and non-renewable (long-term product) | *Tabarru* reserve = PV Future benefit – PV Future *Tabarru* contribution – PV Future investment return (if the policy adopts mudharabah contract)<br><br>Plus<br><br>*Ujrah* reserve = PV Maintenance expense + PV Other guaranteed benefit from Insurer – PV Future *ujrah* – PV Future profit sharing from *Tabarru* fund<br><br>Actuarial assumptions for MfAD | Gross Premium Reserve (GPV) = PV Benefit + PV Maintenance Expenses and Commission – PV Gross Premium<br><br>Actuarial assumptions for MfAD |
| **Claim reserves** | | |
| Outstanding claim reserve (OCR) | At least based on incurred claims which are still in settlement process | |
| Incurred but not reported reserve (IBNR) | Estimated using generally accepted actuarial method | |
| Other reserves | Reserve for guaranteed return or unit-linked fund reserves | |

The new OJK circulated letter number 28 requires insurer to set a reserve for *ujrah* and policyholder investment fund with guaranteed return as an additional reserve requirement from the previous regulation (Per 09/BL/2012). As the regulation will started to roll-out in July 2017, insurers need to prepare additional reserve.

There will be a quite significant financial impact in the balance sheet especially for insurers who previously did not book reserve for *ujrah*, acquisiton expense and maintenance expense but it is subject to sharia business volume.

## What's next?

As this new requirements are starting to roll out in mid of 2017, insurers need to understand the impact on their financial reporting, current systems and processes. Difficulties might arise if maintenance expenses assumptions set by the insurer for sharia products are different and the data needed for the study are not available. For insurers which also sell conventional products, they need to asses their sharia product portfolio and make sure the separation of the company assets formed from *ujrah* contribution and premium from conventional products.

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