Management of liquidity and investments for Takaful institutions in Europe

TAKAFUL & RE-TAKAFUL (EUROPE)

By Ezzedine Ghlamallah

In risk management policy, Takaful covers the following on liquidity risks:

- **the procedure for determining the level of asymmetry between the inflows and outflows of assets and liabilities, including expected cash flows from direct Takaful operations and re-Takaful such as claims, reductions or redemptions**
- **the assessment of total liquidity needs in the short and medium term, including an appropriate reserve of liquidity to guard against a shortage of liquidity**
- **the review of the level and monitoring of liquid assets, including the calculation of potential costs or financial losses due to forced completion**
- **the identification and costs of alternative financing tools, and**
- **the assessment of consequences of planned new activities on the liquidity of a company's portfolio.**

A Takaful company has procedures requiring that where the investment involves significant risk or a material change in the risk profile, the audit and control function of the company discloses that risk or change in the risk profile to the board of directors, administration or supervisory board.

A Takaful company regularly reviews and monitors the security, quality, liquidity and profitability of the portfolio as a whole by reviewing at least:

- any commitment constraint and any known policies regarding future discretionary benefits and, if applicable, reasonable expectations of members
- the level and nature of the risks that the company is willing to accept
- the degree of diversification of the portfolio as a whole
- the characteristics of the assets
- events likely to change the characteristics of the investments, including any guarantees, or to affect the value of the assets, and
- questions relating to the location and availability of assets.

Takaful operators are encouraged to consider investment opportunities in alternative asset classes such as private equity and commodities in order to achieve better diversification. Securities include fixed income securities and variable income securities in relation to capital. For fixed income securities, such as investments in bonds, warrants, treasury bills and other negotiable debt securities, such as commercial papers, they are formally prohibited. These operations are tantamount to lending money for interest, which is formally prohibited by Muslim law.

As a result, all fixed income securities are illegal. Investors can only make a profit if they share the risks. If the borrower guarantees the repayment, the product must come back to him; the alternative acceptable for a Takaful operator is investment in Sukuk, securitized financial products closer to shares than bonds whose performance is linked to the performance of an underlying asset. Sukuk can be seen to behave as a bond with returns that can be known in advance and in cases of default similar to shares where the investor shares the risk of capital loss.

For variable income securities relative to capital, these are primarily equities and mutual fund units. Shares are inherently lawful from the point of view of Islamic law because the common property is acceptable and the income they provide varies.

There are, however, conditions of conformity to Shariah law:

- the social object must be lawful
- the assets of the company must consist mainly of physical assets and not of claims
- the company must not contract loans or interest loans, and
- there cannot be any preferred shares or 'super dividends' because the rights of all shareholders are equal in the capital.

There are also conditions for the legality of mutual fund units since the fund's liquid assets and surpluses must be invested in legal assets and investments made in shares must comply with the rules.

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