Emerald Article: Takaful standards and customer perceptions affecting takaful practices in Pakistan: a survey

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Article information:

Takāful standards and customer perceptions affecting *takāful* practices in Pakistan: a survey

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Abstract

Purpose – The purpose of this paper is to attempt to see the effectiveness of operational and transformational standards raised by joint working group of Islamic Financial Services Board (IFSB) and International Association of Insurance Supervisors (IAIS) as well as respondents' perceptions about *Takāful* (Islamic insurance) practices in Pakistan.

Design/methodology/approach – A total of two questionnaires were designed for this purpose: one for *Takāful* operators in Pakistan and other for insurance customers. For the first questionnaire, three *Takāful* operators were visited at Karachi. For the second questionnaire, a sample of 150 insurance customers was surveyed at Rawalpindi. Descriptive statistics and Chi-square test was used to analyze the data.

Findings – Reporting standards and internal controls were found to have low level of observance among *Takāful* operators in Pakistan. The survey of insurance customers revealed that majority of the respondents (91 percent) are unaware of *Takāful* concept. Education was found to be the single important factor affecting income of the respondents, their perceptions and level of *Takāful* awareness.

Research limitations/implications – The survey is conducted at one major city of the country based on convenient sampling technique and its results have been generalized for the entire country. However, actual results might differ when a sufficiently large sample is taken from all the main cities of the country.

Practical implications – The study would help the policy makers to focus on strengthening regulatory framework for *Takāful*. It will also help *Takāful* operators in understanding public perceptions about *Takāful* and devising strategies to promote *Takāful* business to the vast population of Pakistan.

Originality/value – This is the first empirical research conducted on *Takāful* in Pakistan that analyzes the *Takāful* practices both from managerial perspective as well as from regulatory perspective.

Keywords Operational, Transformational, *Takāful* standards, IAIS, IFSB, *Takāful* perception, Islam, Pakistan, Finance

Paper type Research paper

Introduction

Over the last few years insurance is increasingly recognized as an important component in poverty alleviation strategies. Poor households face difficulty in generating regular and substantial income to save for the future and are extremely vulnerable to economic, political, and physical downturns. A little drop in income

or increase in expense can have a disastrous effect on their already low standard of living. They have limited access to health care facilities; have low literacy rate and poor living conditions. Death, sickness, or accident may force them to dispose their property or some of the productive assets, which in turn further decreases future income and current livelihood. The frequency of losses is also greater for the poor; many are regularly exposed to natural disasters (like flood), fire, and theft with limited means of recovery (Patel, 2004, pp. 3-4).

Given the dominance of Western culture and values as well as plight and vulnerability of today's Islamic world, there has always been an incessant conflict between the two civilizations. Muslims have always been struggling for decades at almost every walk of real life to retain their values and culture. The philosophy behind such struggle is underpinned in powerful expression of collective identity that is multiple and highly diversified following the contours of each culture and historical formation of each identity. The feeling of this collective identity has urged Muslim scholars to find solutions of current economic problems to make their lives compatible with *Sharī'ah* and to safeguard the Muslim *Ummah* against the perils of the Western culture (Yusuf, 2006, pp. 56-63).

As a manifestation of this philosophy behind the theory of collective identity, Islamic finance has emerged as a full fledged discipline in the last two decades. There is urgent need to produce experts in this field to meet the ultimate desires of Muslims as they do not want to live in a state of contradiction between the demands of their faith and realities of life. *Takāful*, a significant element of Islamic finance is a need of today's Muslim world for their sustainable development and to liberate them from the vicious circle of poverty trap and exploitive tools of conventional system.

Takāful is an Islamic way of doing insurance. It is an alternative to conventional insurance and also called Islamic insurance. Basically, the word *Takāful* is derived from the Arabic word "kafl" which means guarantee or responsibility (Billah, 2003). *Takāful* literally means mutually guarantee and solidarity. Takāful Act (1984) of Malaysia defines *Takāful* as:

> [...] a scheme based on mutual assistance, which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for the purpose.

Thus, it is a financial transaction of a mutual co-operation between two parties to protect one of them from unexpected future material risk.

From management point of view, *Takāful* is a system whereby a group of people called participants who agree to pay a certain amount to a fund called *Takāful* fund. The fund is managed by a trustee called *Takāful* Company (also called a *Takāful* operator) who invests the fund in *Sharī'ah* based instruments. Participants are compensated out of this fund in case a loss or catastrophe occurs to any of them.

International Association of Insurance Supervisors (IAIS) has issued insurance core principles (ICPs) that provide prudential standards and a basis for effective regulation and supervision of insurance and reinsurance companies across the globe. Most of those ICPs are also applicable to *Takāful* business, yet *Sharī'ah* compliance feature of *Takāful* business restricts the applicability of certain principles that are only applicable to conventional insurance. In a self assessment exercise of different countries across the globe, many core principles were not fully observed (FO) by the

concerned regulatory bodies (IAIS, 2006). Lack of effective implementation practices of insurance principles has raised different regulatory issues. To judge the effective implementation and applicability of these principles to *Takāful*, Islamic Financial Services Board (IFSB)[1] and Insurance Commission of Jordan co-organized an inaugural seminar on the regulations of *Takāful* (Islamic Insurance) in Jordan on January 2005. As a part of its concerted effort with Insurance commission of Jordon, IFSB took an initial step, to establish a joint working group with the IAIS to produce an issue paper to judge the applicability of the existing IAIS core principles to the regulatory and supervisory standards for *Takāful*.

Takāful industry is faced with numerous operational and transformational issues that may affect its functioning in one way or the other. For example, Chapra and Khan (2000) have found that failure to have adequate internal control systems and lack of effective risk management practices are the major causes of financial crisis in the organizations. Given the newness of *Takāful* industry in Pakistan and intense competition from conventional insurance, Pakistan *Takāful* industry is expected to face serious challenges in the observance of operational and transformational standards that might affect its functioning in future. This study attempts to see the effectiveness of operational and transformational standards raised by joint working group of IFSB and IAIS that also complement the research of previous chapter. The study also encompasses public perceptions about *Takāful* and the factors that affect their level of awareness about *Takāful*.

Maysami and Williams (2006) conducted a survey of 84 respondents in Singapore to judge the perceptions of Muslim community about *Takāful*. They concluded that there is a distinct association between *Takāful* awareness and religious perceptions of the respondents about nature of *Takāful* business (Maysami and Williams, 2006). Extending this concept, present study is more comprehensive in the sense that it not only seeks to find out the factors that are affecting *Takāful* awareness in Pakistan but also sees the impact of *Takāful* awareness on customer loyalty and the factors that significantly affect *Takāful* awareness of people.

The present survey aims to point out operational and transformational standards that are of prime importance to regulatory authority to regulate *Takāful* industry so as to provide a level playing field for new *Takāful* players who are interested to enter into *Takāful* business. This study will provide great help to *Takāful* operators in understanding public perceptions about *Takāful* and devising strategies to promote *Takāful* business to the vast population of the country.

Methodology

This study attempts to make an assessment of operational and transformational standards affecting *Takāful* business in Pakistan as well as pubic perceptions about *Takāful*. Two questionnaires were designed for this purpose: one for *Takāful* operators in Pakistan and other for insurance customers. First questionnaire was used to assess the operational and transformational standards from *Takāful* operators' point of view while the second questionnaire was used to assess customers' perceptions and their level of awareness about *Takāful*. Some of the survey questionnaires were found to be incomplete and some of the insurance customers refused to give answers to the survey questions for personal reasons.

Sample

To assess *Takāful* standards, three *Takāful* operators were selected that constituted the entire *Takāful* industry in Pakistan. They were Pak-Kuwait *Takāful* Company Limited, *Takāful* Pakistan Limited and Pak-Qatar *Takāful* Limited. For public perception survey, 150 insurance customers (policy holders) of State Life Insurance Corporation at Rawalpindi were surveyed under convenient sampling procedure and 142 valid responses were received. State Life is the largest publicly owned insurance company of the country that constitutes 74 percent of the total insurance market of the country. Its customers come from both rural and urban areas of the country so the sample was considered to be an adequate representative of the public perceptions. Since these customers already have insurance policy so they can better give their ideas regarding their awareness about *Takāful* and related questions than those who do not own insurance policy.

Instruments

Two types of questionnaires were used in the survey: one for *Takāful* operators and the other for insurance customers. Questionnaire for *Takāful* operators was adopted from IAIS (2006) report on ICPs, Zaidi (2006) paper on *Sharī'ah* quality rating and Chapra and Ahmed (2002) report on Islamic financial institutions. Questionnaire for the survey of insurance customers was constructed from Maysami and Williams (2006) article on *Takāful* and fundamental perceptions of Islamic principles. To further validate the questionnaire, its contents were discussed with the consultants of Pak-Kuwait *Takāful* and Sidat Hyder Morshed Associates, Karachi and necessary changes were incorporated in the questionnaire.

For the first questionnaire, a total of seven standards including five operational and two transformational standards were assessed in the survey. Operational standards were risk assessment and management practices, corporate governance practices, reporting to securities and Exchange Commission of Pakistan (SECP) and offsite monitoring, internal control mechanisms and fraud detection and prevention measures. Transformational standards were capital adequacy and solvency and existence of *Sharī'ah* compliance mechanisms. Observance of these standards was assessed using essential criteria laid down for each operational and transformational standard.

Second questionnaire related to insurance customer survey was composed of 13 items. First five items represented demographic characteristics of the sample such as age, educational level, gender, marital status and monthly income. Item 6 was categorical and asked the respondents how they came to know about insurance company and its business. Four options were given, i.e. media, sales agents, relatives or other source. Item 7 was a "yes/no" question and asked the respondents whether they were aware about *Takāful* business or not. Next four items (8-11) measured customer perceptions about *Takāful* and were categorized as "yes", "no" and "do not know" options. Item 8 asked the respondents about nature of *Takāful* as a *Sharī'ah* compliant business. Item 9 asked whether *Takāful* was helpful in managing risk and uncertainties in daily life. Item 10 was related to *Sharī'ah* scholars' contradictory views on *Takāful*. Item 11 gauged the perception of the respondents by asking if *Sharī'ah* scholars were fully aware about concept of *Takāful*. Item 12 asked the respondents how they usually paid their insurance premium. Four options were given for it, i.e. monthly, quarterly, semi-annually and annually. Item 13 measured the respondents'

loyalty by asking what they would do if they were given an option to shift the company. This item contained three choices, i.e. stay with State Life, shift to any company and shift to *Takāful* (Islamic Life) Company.

Measures

Takāful standards in the first questionnaire were measured at four levels namely FO; largely observed (LO); partly observed (PO) and not observed (NO). For a standard to be considered FO, it was necessary that the concerned authority had the legal authority to perform its tasks and that it exercises this authority to a satisfactory standard. It was essential for the concerned authority to have the necessary resources to effectively implement the standards. For a standard to be considered as LO, it was necessary that only minor shortcomings exist which did not raise any concerns about the authority's ability to achieve full observance with the standard. A standard was considered PO whenever, despite progress, the shortcomings were sufficient to raise doubts about the management ability to achieve observance of the standard. A standard was considered NO whenever no substantial effort had been made to achieve observance of the standard.

Responses in the insurance customer survey were measured on nominal, ordinal and ratio scale. Nominal scale questions contain responses in the form of yes/no, male/female and single/married options. Most of the ordinal scale questions contain responses in the form of "yes, no and do not know" options. Some of the ordinal questions measure the responses in categories, e.g. questions related to education of customers and their intent to shift to other company were measured in different categories. Age and monthly income of the customers were measured on ratio scale.

Procedure

Data were collected separately for two questionnaires. In the first stage, data regarding observation of *Takāful* standards was collected from CEOs of three *Takāful* operators through personal contact. For this purpose, CEOs of *Takāful* operators were contacted through e-mail. As the headquarters of the three *Takāful* operators are based in Karachi, so a personal visit to Karachi was conducted to meet CEOs of *Takāful* operators.

In the second stage, survey was conducted at State Life building, Rawalpindi. Personal visits were made at the building policy holders' counter where policy holders were asked to give answers of the survey questions. First a pilot study was undertaken to know feedback from customers and to judge the compatibility of findings with the research questions. Then a thorough survey was conducted to reconcile research results with the pilot study.

Data collected from *Takāful* operators as well as from insurance customers were coded in two separate SPSS sheets for analysis. For *Takāful* operators' data, descriptive statistics was applied to describe the level of observance of each standard among *Takāful* operators. Frequency distribution and bar charts were also be used for comparison of different *Takāful* standards. Mean level of observance of each *Takāful* standard was compared to identify those standards that have low level of observance among *Takāful* operators. Comparison of each standard was also shown among three *Takāful* operators using bar charts.

For insurance customers' survey, bar charts and pie-graphs were used to know response of each question. Cross tabulation was applied to judge association of *Takāful* awareness with other variables. χ^2 test was applied to identify the factors that had impact

on *Takāful* awareness. Reliability test was applied to both questionnaires understudy and Cronbach's α was calculated that gives reliability of responses. Cronbach's α for *Takāful* standards questionnaire was found to 0.92 whereas its value for standardized items of customer survey questionnaire was found to be 0.76. Both of the values were found to be in the satisfactory range and ensured the consistency of responses.

Data analysis and interpretations

This section analyses the data obtained from the survey of *Takāful* operators and insurance customers. Interpretations are made to describe the trend of responses according to scale used for their measurement. Key findings given after interpretation of data help to further substantiate the research questions raised in the first chapter and tend to draw necessary recommendations for the final chapter.

Survey results of *Takāful* operators

Survey results of *Takāful* operators include descriptive statistics of *Takāful* standards as well as their comparison among *Takāful* operators.

Table I shows the essential criteria for the observance of overall *Takāful* standards at *Takāful* industry. It could be seen that out of seven standards, risk assessment and management standards have mean observance value of 3.38 and standard deviation of 0.33 units. It indicates that on the average, there is 9.8 percent variation in responses from the mean value. Corporate governance standards have mean observance value of 3.41 and standard deviation of 0.26 units. It indicates that on the average, there is 7.6 percent variation in responses from the mean value. Reporting standards have mean observance value of 2.67 and standard deviation of 0.80 units. It indicates that on the average, there is 30 percent variation in responses from the mean value. Internal controls have mean observance value of 3.17 and standard deviation of 0.76 units. It indicates that on the average, there is 24 percent variation in responses from the mean value. Fraud detection and prevention standards have mean observance value of 3.06 and standard deviation of 0.42 units. It indicates that on the average, there is 13.7 percent variation in responses from the mean value. Capital adequacy and solvency standards have mean observance value of 3.62 and standard deviation of 0.55 units. It indicates that on the average, there is 15.1 percent variation in responses from the mean value. *Sharī'ah* compliance standards have mean observance value

Takāful standards	n	Mean	SD	CV (%)
Descriptive statistics				
1. Risk assessment and management standards	3	3.38	0.33	9.8
2. Corporate governance standards	3	3.41	0.26	7.6
3. Reporting standards	3	2.67	0.80	30
4. Internal controls	3	3.17	0.76	24
5. Fraud detection and prevention standards	3	3.06	0.42	13.7
6. Capital adequacy and solvency standards	3	3.62	0.55	15.1
7. *Sharī'ah* compliance standards	3	3.27	0.31	9.5
Valid N (list wise)	3			

Notes: Coding of data: not observed – 1; partly observed – 2; largely observed – 3; fully observed – 4

Table I.
Measurements of
Takāful standards

of 3.27 and standard deviation of 0.31 units. It indicates that on the average, there is 9.5 percent variation in responses from the mean value.

Table I further indicates that capital adequacy and solvency standards have maximum observance value, i.e. 3.62 while reporting standards have least observance value, i.e. 2.67. Responses on corporate governance standards were found to be more concentrated towards mean value as they have minimum variation of 7.6 percent. On the other hand, responses on reporting standards were found to be more dispersed as they have 30 percent variation from the mean that is maximum of all as expressed by coefficient of variation (CV).

Figure 1 shows the level of observance of *Takāful* standards at *Takāful* industry. The standards were arranged in descending order with first standard having highest level of observance and last standard having lowest level of observance. It could be seen that out of seven standards, capital adequacy and solvency standards were found to have maximum observance value, i.e. 3.62 while reporting standards were found to have least observance value, i.e. 2.67.

Figure 2 shows the percentage of variation of *Takāful* standards at *Takāful* industry. The standards were arranged in descending order and variation is measured by estimating CV for each standard. First standard has the highest percentage of
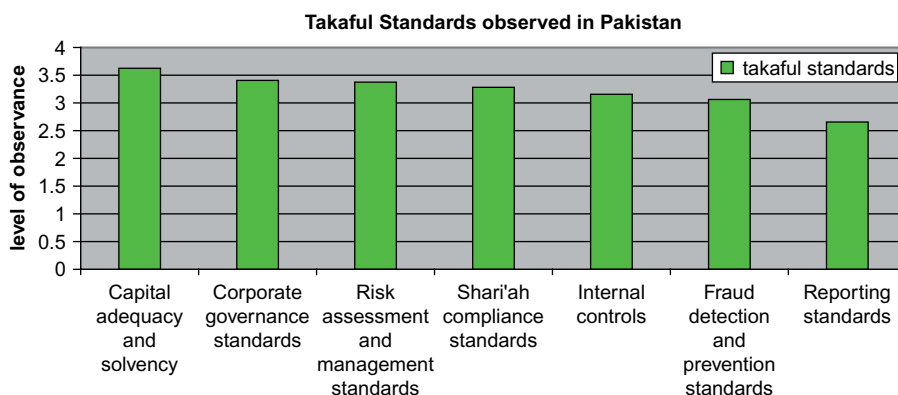
Notes: Coding of data: not observed – 1; partly observed – 2; largely observed – 3; fully observed – 4
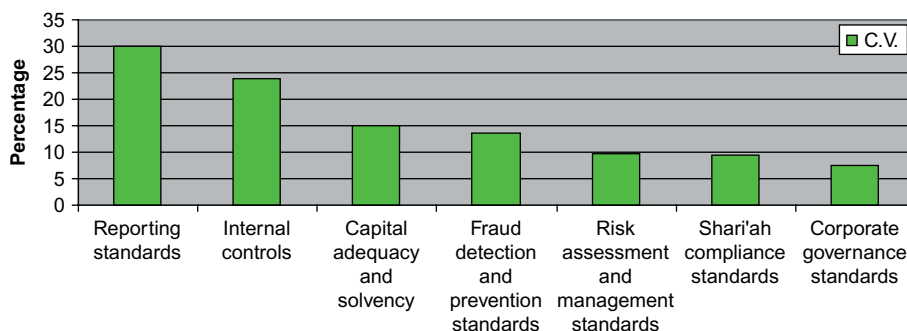
Figure 1.
Takāful standards

Figure 2.
Variation in *Takāful* standards

variation and last standard has the lowest variation. It could be seen that out of seven standards, reporting standards were found to have highest percentage of variation, i.e. 30 percent while corporate governance standards were found to have least percentage of variation, i.e. 7.6 percent.

It can be seen from the chart that responses on corporate governance standards, *Sharī'ah* compliance standards and risk assessment and management standards have less than 10 percent variation. Fraud detection and prevention standards as well as capital adequacy and solvency standards have variation between 10 and 20 percent. While internal controls and reporting standards have more than 20 percent variation.

Observance of standards among *Takāful* operators

The following standards compare the observance of *Takāful* standards among the three *Takāful* operators. Level of observance for each standard has been calculated from the responses received from each *Takāful* operator. It is based on mean value of essential criteria for each standard as described above.

Figure 3 shows the level of observance of *Takāful* standards among three *Takāful* operators surveyed in Pakistan, namely Pak-Kuwait *Takāful* Company Limited, *Takāful* Pakistan Limited and Pak-Qatar *Takāful* Limited. At *Takāful* Pakistan Limited, standards 3 and 4 (reporting standards and internal control) were found to have low level of observance as compared to other *Takāful* operators. It indicates that reporting standards and internal controls are PO at *Takāful* Pakistan Limited. At Pak-Kuwait *Takāful* Company Limited, standards 3 and 5 were found to have LO while all other standards were full level of observance. It indicates that reporting standards and fraud detection and prevention standards were LO at Pak-Kuwait
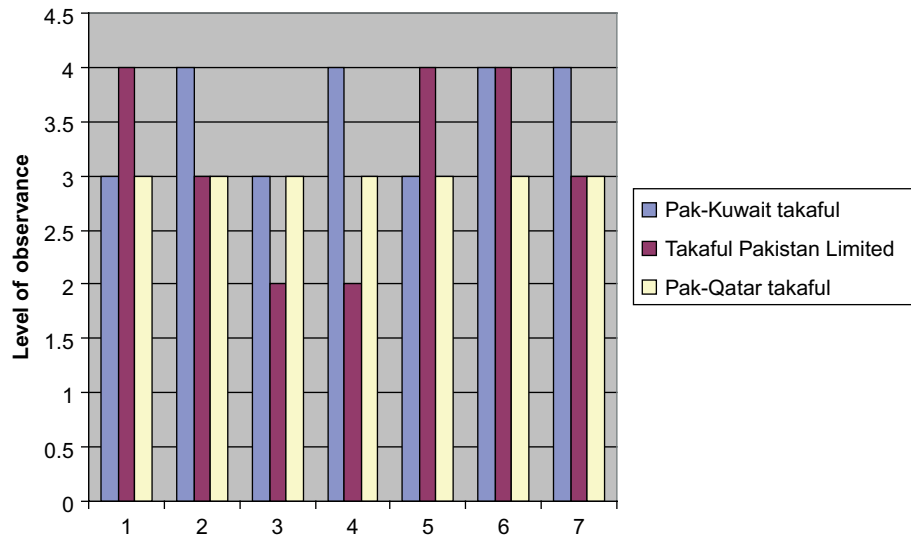

Figure 3.
Takāful standards among *Takāful* operators

Notes: Coding of data: not observed – 1; partly observed – 2; largely observed – 3; fully observed – 4

Takāful Company Limited. At Pak-Qatar *Takāful* Limited, all the standards were LO and not a single standard was FO or less than LO.

Figure 4 shows the average level of observance of *Takāful* standards among three *Takāful* operators surveyed in Pakistan, namely Pak-Kuwait *Takāful* Company Limited, *Takāful* Pakistan Limited and Pak-Qatar *Takāful* Limited. It could be seen from the above graph that Pak-Kuwait *Takāful* Company Limited has higher level of average observance of *Takāful* standards than both of *Takāful* Pakistan Limited and Pak-Qatar *Takāful*. Moreover, *Takāful* Pakistan was found to have higher level of average observance than Pak-Qatar *Takāful*.

Survey results of insurance customers

Survey results of insurance customers include demographic statistics of insurance customers, factors associated with their level of *Takāful* awareness and impact of education.

Main findings for observance of *Takāful* standards as well as respondents' perceptions about *Takāful* were found to be as follow.

Observance of Takāful standards

- Reporting standards and were found to have low level of overall observance among *Takāful* operators in Pakistan.
- Reporting standards and internal control were found to have higher level of variation among *Takāful* operators in Pakistan.
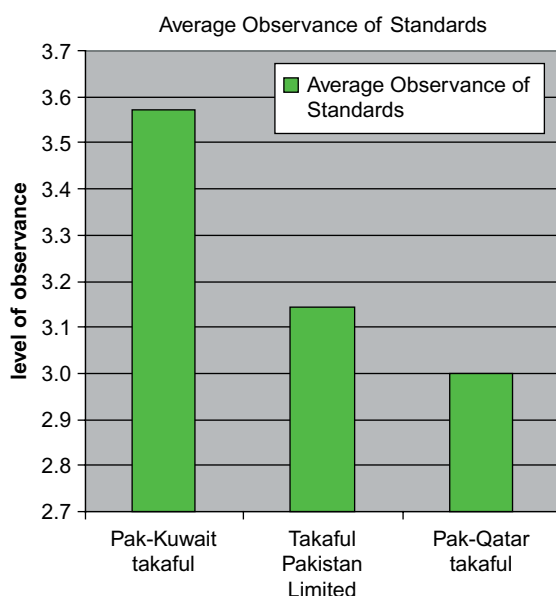
Notes: Coding of data: not observed – 1; partly observed – 2; largely observed – 3; fully observed – 4

Figure 4.
Average observance of
Takāful standards

- Pak-Qatar *Takāful* was found to have lower level of average observance of *Takāful* standards than both of *Takāful* Pakistan Limited and Pak-Kuwait *Takāful* Company Limited. Moreover, *Takāful* Pakistan was found to have lower level of average observance than Pak-Kuwait *Takāful* Company.

Respondents' perceptions about Takāful
Table II summarizes the key findings about respondents' perceptions as follow:

- A large population of the country (90.8 percent) including educated class is unaware of *Takāful* business.

- A significant association was found between education of the respondents and their level of *Takāful* awareness ($p < 1$ percent).

- A significant association was found between perceptions of the customers about *Takāful* as a *Sharī'ah* compliant business and their level of *Takāful* awareness ($p < 1$ percent).

- A significant association was found between perceptions of the customers about *Takāful* as a useful risk management tool in daily life and their level of *Takāful* awareness ($p < 1$ percent).

- *Takāful* awareness was found to be unaffected by age, gender, monthly income, marital status and previous knowledge of insurance business. It was also found that *Takāful* awareness has no significant relationship with respondents' views about *Sharī'ah* scholars and their payment pattern of insurance premium.

- A significant association was found between customers' intention to shift to a *Takāful* Company and their level of *Takāful* awareness ($p < 5$ percent).

Factors affecting *Takāful* awareness	No. of valid responses	Pearson χ^2	Degree of freedom (df)	Level of significance
Age	142	0.447	4	0.978
Education	142	23.490 *	3	0.000
Gender	142	0.668	1	0.414
Monthly income	142	7.655	4	0.105
Marital status	142	1.58	1	0.691
Channels of distribution of insurance	142	1.219	3	0.748
Takāful as a *Sharī'ah* compliant business	142	129.976 *	2	0.000
Perception of *Takāful* as a risk management tool	142	130.071 *	2	0.000
Perception of *Sharī'ah* scholars' views on *Takāful*	142	0.707	2	0.702
Perception of *Sharī'ah* scholars' awareness about *Takāful*	142	0.911	2	0.634
Payment pattern of insurance premium	142	0.811	3	0.847
Option to shift the company	142	6.753 **	2	0.034

Table II.
Factors associated with *Takāful* awareness

Note: The results are significant at: *1 ($p < 0.01$) and **5 ($p < 0.05$) percent levels

Impact of education

- A significant association was found between education of the respondents and their monthly income ($p < 1$ percent).
- A significant linear by linear association was found between education of the respondents and their intention to shift to a *Takāful* Company ($p < 10$ percent).

In the survey of *Takāful* operators, observance of *Takāful* standards can be associated with newness of *Takāful* operator in the industry as Pak-Qatar was found to have low level of observance than other two *Takāful* operators. In customer insurance survey, education was found to be an important factor shaping perceptions of the respondents, affecting their income level as well as their level of *Takāful* awareness.

Policy implications

Following policy implications for SECP can be drawn from the above analysis that could be used to develop a dynamic *Takāful* industry in Pakistan:

- At present *Takāful* industry mostly benefits from infrastructure that supports the conventional industry such as equity institutions, legal and supervisory framework, etc. there is need to strengthen supporting institutions to specifically meet the requirements of *Takāful* industry, e.g. separate legislation, developing *Sharī'ah* governance and supervisory framework, etc.
- Education was found to be single important factor affecting *Takāful* awareness of people as well as their perceptions. It requires immediate attention of policy makers as well as *Takāful* players to devise long-term strategies and focus on education of general public.
- Enhancing the internal control structures within the *Takāful* operator is essential as they were found to have low level of observance among the companies. Special focus should be maintained on corporate governance and risk management practices.
- Each *Takāful* operator should conduct internal audit of the business operations and transactions on continuous basis. Company internal audit function should be given appropriate status and resources by the senior management and B.O.D.
- *Takāful* operators should disclose their financial information to general public on timely basis. Financial statements showing the past financial performance of the company should be readily available to general public. It will establish the credibility of the company and build public confidence. Moreover, proper disclosure will provide an opportunity to local investors to immediately make their investment decisions.
- Reporting standards will provide great help to the regulatory authority to analyze company's financial performance and take steps for effective offsite monitoring of *Takāful* operators in the best interest of general public.
- Reporting of outsourced functions of the company's on-going business in addition to its regular reporting should be made available to regulatory authority on quarterly, semi-annually or annually according to requirement of the concerned authority.

Conclusion

Sound state policies followed by effective regulatory standards are critical factors for the success of *Takāful* industry in the country. Survey results brought to light some useful insights that are of prime importance to SECP on one hand and to help *Takāful* operators to devise strategies to promote *Takāful* business on the other hand. Reporting standards and internal controls should be the focus of regulatory authority to strengthen regulatory standards for *Takāful*. Otherwise, Pakistan *Takāful* industry might be at the edge of losing its credibility and public confidence due to inefficient reporting and lack of adequate internal control systems. Results of insurance customer survey revealed that a large majority of respondents (90.8 percent) is unaware of *Takāful* business. To boost *Takāful* business, it is pertinent to create its awareness among general public. Education can be used as a tool to raise earning capability of people, uplifting their standard of living and at the same time providing them spiritual relief by making *Takāful* available at their doorstep. It will fulfill their ultimate desire of having *Sharī'ah* compliant financial protection in the form of *Takāful* for which they have aspired for a long time.

Note

1. IFSB is an international standard-setting organization that issues global prudential standards and guiding principles for the Islamic financial services industry. It enhances the soundness and stability of these established standards for Islamic banks and *Takāful* companies.

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