PalArch's Journal of Archaeology of Egypt / Egyptology

CREDIT RISK MANAGEMENT IN TAKAFUL INDUSTRY IN THE KSA

Doha Banoon[1], Tahar Tayachi[2]

[1,2] Effat College of Business, Effat University Qasr Khuzam St.,Kilo. 2, Old Mecca Road.

P.O.BOX 34689 Jeddah 21478 Saudi Arabia

Email: [1]djbanoon@effatuniversity.edu.sa, [2]ttayachi@effatuniversity.edu.sa

Doha Banoon, Tahar Tayachi. Credit Risk Management in Takaful Industry in The Ksa -- Palarch's Journal of Archaeology of Egypt/Egyptology 18(13), 1243-1250. ISSN 1567-214x

Keywords: Credit Risk, Credit Risk Management, Framework, Saudi Arabia, Takaful.

ABSTRACT

Risk needs to be addressed promptly as it affects the return that is associated with it. Credit risk is one of the types of risk, and its management is highly efficient in different industries. The achievement of credit risk by executives requires the support of legitimate acknowledgement of opportunity conditions along with appropriate credit methodologies and approaches. In accordance, this study focuses specifically on Takaful (insurance company) in Saudi Arabia. The aim of the study is to provide a framework for the management of credit risk in Takaful (insurance company) by studying and analyzing various measures to control credit risk. The methodology used will be of a qualitative nature as a result of the literature analysis carried out in the study. The results concluded that the various credit risk management systems in Takaful have enabled the Saudi Takaful industry to be safe by the various credit verification procedures, which are adapted before trading. Such policies of credit risk management are helpful to the Saudi Takaful industry in terms of financial strength.

INTRODUCTION

Credit risk is characterized as the possibility that the creditor or contractor of a financial institution may fail to fulfill the requirements set out in the terms and conditions agreed [1]. It is often variously referred to as the default in the success of counterpart risk. Commonly, credit risk is the collateral risk that will apply to the financial institution when the counterparty fails to pay on time. Credit risk is also one of the most important risks for any commercial financial entity, since this risk comes from the non-performance of the borrowing party [2]. Credit risk can also result from the failure or reluctance of the creditor to behave in a committed and contractual manner. Credit is also one of the big threats facing banks and financial institutions. True credit risk occurs when portfolio output is deviated from the anticipated value and thus the bank's credit risk often influences the bank's book value. The more collateral exposure the bank has, the more profitability the bank has to be insolvent [3].

Credit risk is present in all sectors of financial services and economies, but most notably in the banking sector. In banks, collateral risk is part of the bulk of the balance sheet reserves and the off-balance sheet disbursement sequence of bank enrollments or guarantees [4]. Credit risk often occurs when entering into derivative contracts, security loans, repurchase contracts and agreements. In order to prevent crises and uncertainties related to these causes, banks seek to adjust the different credit risk management techniques and policies to safeguard the interests of consumers and to increase the efficiency of the service offered by the financial institution [5].

The prime goal of credit risk mitigation is to optimise the bank's rate of return, which is regulated by risk, by holding credit risk tolerance under appropriate criteria [6]. Effective management of credit risk includes the preservation of an acceptable credit risk environment, along with appropriate credit strategy and policies. Furthermore, the primary goal of credit risk management is to protect and improve the credit rating of the financial institution. Likewise, financial risk assessment shall be carried out in a manner suitable to the planning procedures and structure of the risk management system. The primary goal of the credit risk management system is to improve the value of assets and minimize non-performing assets. It also guarantees the optimum position of the loan as well as progresses in the banks with their effective management [7].

The credit risk management scheme is important, as both successful acquisitions of loans and the bank's sales operations have an effect on the bank's investment. These loans can be speculative, and banks that buy and sell loans are at greater risk in terms of credit, default loans as well as commercial real estate loans. These banks have a greater proportion of volatile loans on the balance sheet than most banks [8]. Commercial banks typically tend to bear all sorts of credit losses related to defaults on the part of the parties to the deal. The credit management scheme in these banks is important in order to facilitate the growth of the bank and prevent excessive losses. However, in the case of larger banks, the lending of these banks is less prone to shifts in cash flow and capital [9]. In the case of smaller financial institutions, deposit and supply movements have a bearing on the loading process, as these small banks do not have access to the large internal capital market.

Various approaches are used by banks to manage credit risk, and are primarily used to measure and evaluate credit risk [10]. These methods are also important to the smooth operation of the bank. Each bank creates its own risk probability evaluation model to evaluate the credit risk. In addition, in order to analyze, anticipate and control credit-related risks, each bank must calculate the applicable credit risk factors that allow banks to estimate the risks involved and to track these credit risk factors on a permanent basis [11]. The establishment of these systematic and functional appraisal processes is of positive value to the banks and leads to a thorough change in the management level of the bank, as well as to the reduction and avoidance of credit risks. The borrower's appraisal includes studying and assessing the qualitative and quantitative metrics of the borrower's economic condition [12]. These measures allow the banks to take into account and control the potential credit risk in order to minimize adverse effects on the bank.

The Saudi insurance industry is made up of all Saudi insurers working under the Takaful scheme, also known as the Islamic Cooperative Insurance Scheme [13]. In this type of insurance scheme, the financial statements of the insurer consist of separate financial statements, profit or loss statements and cash balance statements for insurance transactions or policyholders as well as for owners. Takaful is a well-planned Islamic financial preparation framework that involves the elimination of financial costs in the event of any unexpected events, damages and misfortunes [14]. However, there are three steps which can be considered to be profitable for the Takaful industry. These are the gross benefit, the written benefit, and the investment income.

Risk management is of crucial significance, according to Islam, and the Takaful scheme of loans offers a method of handling these risks in compliance with the values of Shariah [15]. The reforms in the Saudi Takaful industry commenced with the establishment of National Company for Cooperative Insurance (NCCI) in 1986 [13]. This enables the Takaful to be driven by the principles of mutuality and co-operation in the Kingdom of Saudi Arabia. The major factor of credit risk management in Saudi Takaful industry is the uncertainty and forbidden practices as per the Islamic rulings. There are various policies adapted by the Takaful industry in the Kingdom of Saudi Arabia in order to ensure appropriate management of credit risk. Thus, this work has examined the framework used in the credit risk management for Takaful (insurance company) in Saudi Arabia.

METHODOLOGY

The methodology used in this research is qualitative in nature due to the case study and literature analysis done by the authors. The data used by the authors is secondary data as it is collected from various sources like magazines, reports, websites, journals, etc. The data is analyzed based on the graphs retrieved from these sources.

RESULT AND DISCUSSION

Performance of Takaful Industry

The growth rates of global Takaful markets have been rapid and are estimated to be around 20% over the past few years with global Islamic finance growing at 15% annually [16]. Takaful industry is increasingly appealing to both Muslim and non-Muslims which is a key factor in its enhanced performance in the financial sector of the world. The contributions of Takaful industry were expected to reach 20 billion USD in 2017. As of 2015, there were more than 110 Takaful operators all across the world [16]

Figure 1 depicts the concentration of Takaful industries across the world. Apart from Middle-eastern regions, South-east Asia is known to be the second major market for Takaful operators, followed by the African subcontinent and the Indian subcontinent [17] The global Takaful industry grew to 14 billion USD in the year 2014 with a healthy growth rate of 14% particularly in the Family Takaful in the Middle-eastern countries and South-east Asian countries [17].

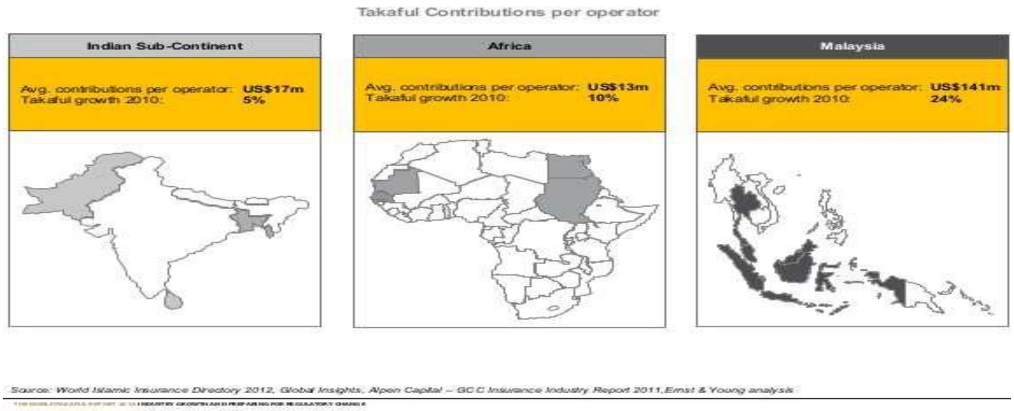


Figure 1. Operation of Takaful Industry

The Takaful operators from Malaysia have set up various joint ventures in Pakistan, KSA and Sri Lanka and these provided a wide range of technical expertise to other countries in the Asian region such as Indonesia, Bangladesh, Lebanon, Brunei etc. The growth of Takaful operators had large conglomerates, which were coming from the Middle Eastern countries with positive returns on their investment. These were factors, which increased the performance of Takaful industry on a global scale. Furthermore, most of the non-Muslim co-operations also joined the Muslim counterparts of Takaful industry in various areas of the world. This in turn excited the prospect of making big money for the dealers in the interest-free Takaful market [18].

The financial market in London had also launched the Takaful Syndicate at Lloyd’s in the year 2005. This establishment had the underwritten capacity of 72 million USD, which enabled the Takaful industry to expand and perform further in the Western markets. The spread of Takaful industry was noted in the financial markets of US, Canada as well as Western Europe [19]. The first Shariah complaint insurance system in Britain was the Principal insurance which was targeted at the 2 million Muslims residing in Britain. Furthermore, in other non-Muslim or Muslim minority countries such as Thailand which practices Buddhism, they had also opened their financial markets to the incoming benefits from the performance of Takaful industry. In Thailand the Takaful industry was established as Kamol industry, which was a Shariah complaint insurer, aimed to attract the Muslims in the financial market. Figure 2 shows the global takaful contribution [19].

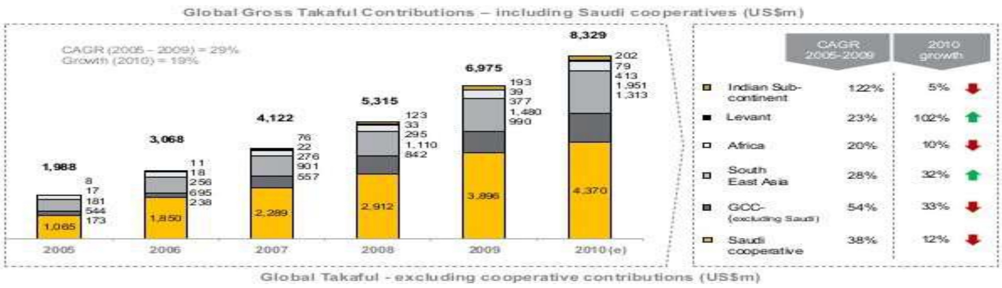


Figure 2. Global Takaful Contribution

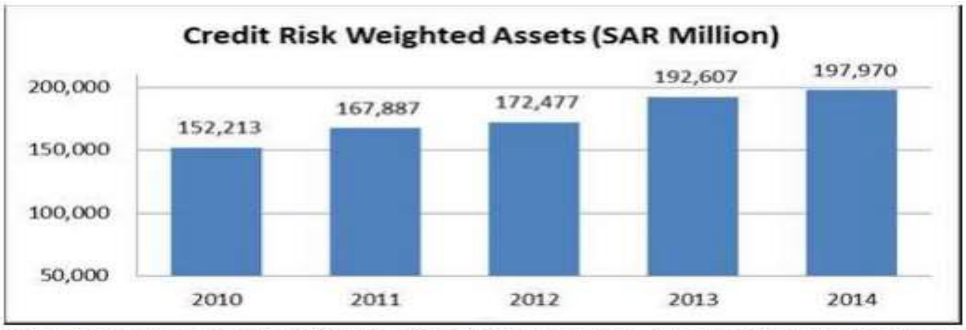
Furthermore, the Takaful industry in Thailand was known to cross over to Malaysia in order to make their Takaful purchases [20]. The other non-Muslim country based financial institutions such as the American International Group (AIG), which is known to be one of the largest insurers in the world, has also begun operations of its Takaful industry units in Bahrain. Allianz is another largest insurer in Europe, Hannover Re is a large insurer in Germany, and Swiss Re which is a Switzerland based reinsurance company have all penetrated the gulf market recently which Shariah compliant insurance techniques. These companies have started offering Takaful options and products in the country of their origin which is its domestic financial market. This performance of Takaful in the non-Muslim countries of the world is a major force for driving its success as well as its creditability [19]

Impact of Credit Risk Management in Takaful Industry Of KSA

With the expansion of Islamic finance in the Kingdom of Saudi Arabia, there has been a remarkable growth in the Takaful industry of the Kingdom as well. This is mainly attributed to the expanded compulsory insurance particularly in the healthcare and the vehicle insurance sectors of the Kingdom of Saudi Arabia. The gross written premiums had increased significantly up to 33.8% in the year 2009 and there was a predicted increase in the Takaful sector by 3.9 billion USD which approximates to 14.6 billion Saudi Riyal in the year 2015 [20]

The various schemes of managing credit risk in the Takaful industry have led to the increase in Saudi Takaful system. The credit risk management, which ensures the reduction of risks is case of unforeseen accidents, losses as well as misfortunes, is a major driver for the increased performance of Saudi Takaful industry. Despite the fact that the Saudi Takaful industry is relatively new as compared to the Takaful industries of other countries, there are various changes in the development of insurance related concepts in the Saudi financial market, which make the Saudi Takaful system more efficient in managing risks. This also enables the Takaful industry in the Kingdom to be more acceptable by the citizens on religious terms as well [20] The GCC countries are known to have the highest number of Takaful operators and as depicted in the image above, the Kingdom of Saudi Arabia had an average growth in the Takaful industry by 12% in 2010 [21].

Various financial organizations have limited the credit terms extended to the corporate clients; this has enabled the Takaful industry in the Kingdom to manage its credit risks. Furthermore, the Takaful insurers in the Kingdom are engaging in reputable reinsurers with minimum foreign currency rating such effective collection of policies and diversified investments strategies aid the Saudi Takaful industry to prosper (SABB, 2008). Figure 3 shows the credit risk weighted assets [22].



** For the purposes of presentation, the Credit RWAs, after 2012 are calculated using the framework and the methodologies defined under the Basel III framework. The comparative balances for 2012 and earlier years are calculated under Basel II and have not been restated.*

Figure 3. Credit Risk Weighted Assets

The Saudi Arabian Monetary Agency (SAMA) had also adopted the Standardized Approach which is used for measuring the credit risk for the purpose of capital adequacy [23]. The Saudi financial institutions calculate the credit risk capital assessment by extraction of all credit risk exposures. This contains the risk categories along with risk mapping which is suitable to the asset. SAMA had also issued guidelines to be followed by the baking sector employees working under the Takaful industry in the Kingdom, and these employees are instructed to strictly follow the international practices in order to meet the obligations [23] Another important factor of credit risk management is the transparency and disclosure which is important for gaining the trust of the clients and the Saudi financial institutions have focused on clarifying the rights, responsibilities and the duties of all the parties involved in the Takaful relationship [24].

CONCLUSION

This study has examined the framework used in the credit risk management for Takaful (insurance company) in Saudi Arabia. The various credit risk management systems in Takaful have enabled the Saudi Takaful industry to be safe by the various credit verification procedures, which are adapted before trading. This safeguards the Saudi Takaful insurers from the exposure to bad debts and financial losses. Furthermore, cash and cash equivalents are maintained by the Saudi Banks, which enable the Takaful system of these banks to be insured against potential losses. The presence of policies and procedures such as the minimization of Takaful industry exposure to significant credit losses from insolvencies in re-Takaful is another important factor. This enables the Saudi Takaful insurers to evaluate the financial condition of their counterparties and accordingly as a pre-requisite, the various parties effecting re-Takaful are required to have minimum acceptable rating in terms of security.

REFERENCES

Berndt, A., Douglas, R., Duffie, D., & Ferguson, M. (2018). Corporate credit risk premia. *Review of Finance*, *22*(2), 419-454.

Addo, P. M., Guegan, D., & Hassani, B. (2018). Credit risk analysis using machine and deep learning models. *Risks*, *6*(2), 38.

Ghenimi, A., Chaibi, H., & Omri, M. A. B. (2017). The effects of liquidity risk and credit risk on bank stability: Evidence from the MENA region. *Borsa Istanbul Review*, *17*(4), 238-248.

Hassan, M. K., Khan, A., & Paltrinieri, A. (2019). Liquidity risk, credit risk and stability in Islamic and conventional banks. *Research in International Business and Finance*, *48*, 17-31.

Zamore, S., Ohene Djan, K., Alon, I., & Hobdari, B. (2018). Credit risk research: Review and agenda. *Emerging Markets Finance and Trade*, *54*(4), 811-835.

Baesens, B., Roesch, D., & Scheule, H. (2016). Credit risk analytics: Measurement techniques, applications, and examples in SAS. John Wiley & Sons.

Al Amine, M. A. B. M. (2016). Commercial credit takaful. In *Takaful and Islamic Cooperative Finance*. Edward Elgar Publishing.

Hassan, H. A. (2019). Takaful models: origin, progression and future. *Journal of Islamic Marketing*.

Alokla, J., & Daynes, A. (2017). Risk Management in the Takaful Industry: An Empirical Study of the Kuwaiti Market. *Journal of Islamic Economics, Banking and Finance*, *113*(6223), 1-21.

Belás, J., Mišanková, M., Schönfeld, J., & Gavurová, B. (2017). Credit risk management: financial safety and sustainability aspects. *Journal of Security and Sustainability Issues*.

Koulafetis, P. (2017). Modern Credit Risk Management: Theory and Practice. Springer.

Samorodov, B. V., Azarenkova, G. M., Golovko, O. G., Miroshnik, O. Y., & Babenko, M. V. (2019). Credit risk management in the bank's financial stability system. *Financial and credit activity: problems of theory and practice*, *4*(31), 301-310.

Mohammed Saad, A., Islam, R., Noor, M. S. Z., Ali, J., & Zainal, Z. (2016). Consequences of service quality in the insurance industry: A case study on Saudi Arabia insurance industry. *International Business Management*, *10*(3), 209-217.

Albalawi, K. M. (2019). The Evaluation of Saudi Insurance Industry and Potential for Takaful Insurance. *International Journal of Business Society*, *3*(11), 22-37.

Toukabri, M. T., & Ibrahim, H. H. (2016). Challenges and ways to develop insurance industry in KSA market. *International and Multidisciplinary Journal of Social Sciences*, *5*(2), 152-182.

Othman, M. B. (2017). Development and shari'ah issues of the takaful industry in malaysia–effects of the regulatory framework on the implementation and growth. *Journal of Finance and Banking Review*, *2*(1), 38-43.

Lone, F. A. (2016). Islamic Finance—An Overview. In *Islamic Banks and Financial Institutions* (pp. 41-65). Palgrave Macmillan, London.

Sherif, M., & Hussnain, S. (2017). Family Takaful in developing countries: the case of Middle East and North Africa (MENA). *International Journal of Islamic and Middle Eastern Finance and Management*.

Hassan, H. A. (2019). Takaful models: origin, progression and future. *Journal of Islamic Marketing*.

Khairi, K. F., Laili, N. H., & Kamarubahrin, A. F. (2020). Malaysian Consumer Intention toward Takaful Scheme for Mental Health Disorders. *Journal of Finance and Islamic Banking*, *3*(1), 1-20.

Hemrit, W. (2020). Determinants driving Takaful and cooperative insurance financial performance in Saudi Arabia. *Journal of Accounting & Organizational Change*.

Akhtar, M. H. (2018). Performance analysis of Takaful and conventional insurance companies in Saudi Arabia. *Benchmarking: An International Journal*.

Benyoussef, S., & Hemrit, W. (2019). Measuring the relative efficiency of insurance companies in Saudi Arabia: The case study of Takaful vs cooperative industries. *Cogent Economics & Finance*, *7*(1), 1590818.

Guendouz, A. A., & Ouassaf, S. (2018). Determinants of Saudi Takaful Insurance Companies Profitability. *Academy of Accounting and Financial Studies Journal*, *22*(5), 1-24.