

CHAPTER 1

INTRODUCTION

1.1 Background of Study

As insurance is common in our world and a vital component of the larger financial services sector, the insurance business is essential to managing and reducing the risks that people and companies face on a daily basis. At its core, insurance works as a contract between an insurance provider and a person or organization known as the policyholder. In accordance with this agreement, the insurer agrees to pay periodic premiums in exchange for financial assurance against specified risks or losses (Insurance Information Institute, 2010).

Essentially, the main objective of insurance is to give policyholders a safety net by shifting the financial weight of unexpected events or responsibilities to the insurance company. Due to the existence of a safety net in place to lessen the effect of unforeseen catastrophes, this risk transfer mechanism gives people and organizations the confidence to prepare for the future. The insurance industry is normally divided into life and non-life products, while in the United States, this is more commonly referred to as life/annuities and property/casualty (Insurance Information Institute, 2020).

In addition, the insurance sector offers a wide range of goods made to satisfy different needs. These goods include life and health insurance, business commercial insurance, liability, and property insurance for homes and cars, as well as specialized insurance such as pet or event insurance. It is a crucial tool for risk management, guarding against monetary losses brought on by illnesses, mishaps, natural catastrophes,

liability claims, and other unforeseen events. By spreading these risks over a wide number of policyholders, insurers are able to provide coverage at reasonable costs from the premiums being paid by policyholders.

On the other hand, insurance companies have used statistical and mathematical methods to determine reserves, calculate premiums, and evaluate risk, as performed by actuaries. Regulation is another important aspect of the insurance industry, with regulatory agencies in most countries setting guidelines that cover claims processing, capital requirements, and ethical conduct to protect policyholders and maintain the financial integrity of insurance enterprises. Actuaries have a significant role in supporting the financial stability of insurance companies and ensuring the appropriate pricing of insurance products. With the emergence of new risks, such as climate change and natural disasters like severe floods, the regulatory procedures also change and are improvised. For example, the pressure coming from investors and the financial market has fastened the risk management initiative to net-zero greenhouse emissions in the next few decades. This will, in turn, have a significant impact on the insurance and reinsurance underwriting portfolios (Faber Consulting AG, 2022).

Furthermore, insurance firms also engage in prudent financial management, typically investing the premiums they collect in a variety of financial instruments to generate returns. This financial prudence enables them to fund claim settlements and cover operational costs.

The impact of insurance extends globally, holding profound implications for economic stability, societal resilience, and the well-being of individuals and businesses.

Insurance's worldwide reach and influence are further demonstrated by the fact that it

is a vital instrument for nations trying to recover from natural catastrophes and catastrophic occurrences.

In summary, insurance plays a crucial role in the financial services sector by providing security and assurance to both consumers and businesses, which in turn promotes economic stability. The sector, which covers a wide range of goods, needs advanced risk management and analysis, all carried out under strict regulatory oversight. The industry continues to be an essential component of the contemporary financial environment despite its constant adaptation to changing needs and improvements in technology.

1.2 Overview of the Insurance Industry in Malaysia

The insurance sector in Malaysia is a fundamental component of the nation's financial services industry, demonstrating substantial expansion and serving as a vital contributor to economic stability. Under the governance of the Central Bank of Malaysia (Bank Negara Malaysia, BNM), the industry has demonstrated significant advancement, particularly in the life insurance market, where it attained a penetration rate of 54% in 2022. However, the takaful sector, which follows Islamic financial principles, achieved a penetration rate of only 19% in 2021, much below BNM's ambitious aim of 75% (PwC, 2023).

Malaysia continues to operate with two distinct financial systems: Islamic and conventional. Under this setup, the Islamic system rigorously abides by Shariah rules, avoiding *riba* (interest), *gharar* (uncertainty), and *maysir* (gambling) and emphasizing Islamic values. In contrast, the conventional system is constructed around interest-based financial processes (Eldaia et al., 2020). This dual system is designed to cater to the varied financial inclinations of Malaysia's people, affording them access to a spectrum

of financial services that align with their preferences, be they conventional or Shariah-compliant. Regulatory oversight by entities such as Bank Negara Malaysia and the Securities Commission Malaysia is paramount, ensuring the adherence to established standards of compliance and upholding the integrity of financial products and services.

There are various types of insurance products available in Malaysia. This includes whole life, term life, endowment life, and investment-linked insurance policies, which are among the products included in the life insurance category. In Malaysia, life insurance is an essential part of both individual and family financial planning. Moreover, both domestic and foreign insurance businesses, including major multinational insurers, are present in the Malaysian insurance market, where Prudential Malaysia, Great Eastern Life Assurance, Allianz Malaysia, and Zurich Malaysia are a few of the well-known companies in the Malaysian insurance sector.

The insurance sector falls under the regulatory purview of the Bank Negara Malaysia (BNM), which is responsible for ensuring the financial stability and solvency of insurance entities through the establishment of prudential norms, capital requirements, and routine inspections. Additionally, BNM actively supports the growth of the takaful sector, aligning with Islamic financial principles.

Even with this growth, Malaysia's insurance penetration rate is still low when compared to other wealthy countries (Sang et al., 2020). There are ongoing efforts to rectify this inequality, especially with respect to the population's lower-income groups. Comprehensive financial literacy programs that make use of seminars, workshops, and instructional materials are among the initiatives. Furthermore, customized microinsurance products offer coverage for important risks, including health,

agriculture, and small enterprises, to meet the unique needs of low-income people and communities.

The developmental trajectory of the Malaysian insurance market has exhibited consistent growth, driven by factors such as the burgeoning middle class, increasing prosperity, and heightened awareness of insurance products. Notably, government initiatives aimed at bolstering vehicle insurance penetration have contributed significantly to the broader promotion of insurance coverage. A study by Hassan et al. (2018) found from 503 respondents who reside in Kuala Lumpur and Selangor, an estimated 25% have no knowledge of takaful, while 45% do not know that they mutually share the risks in a takaful policy.

The low penetration rate and awareness could stem from the complexities linked to such insurance/takaful products and policies, as mentioned by Sang et al. (2020), causing people to become less interested in knowing more about them. This is worsened by the use of high-level language that includes legal terms which is often difficult for many to understand

Government subsidies also contribute to improved accessibility by providing financial aid to underprivileged populations and lowering entry-level costs. Insurance roadshows in both urban and rural regions are examples of cooperative initiatives between regulatory organizations and insurance companies that seek to raise awareness by offering consultations along with policy information.

Furthermore, the emergence of digital platforms and mobile applications has greatly enhanced accessibility to insurance services and information, making the purchasing process easier for a larger audience. In addition, community engagement tactics—such as collaborations with nearby leaders and organizations—help to advance

trust and understanding of insurance in local areas. The advent of microinsurance, which is a term used to represent insurance for low-income people, is especially required by those residing in rural areas and poor urban locations who basically have no or limited access to formal social protection schemes (Afendi & Jacob, 2023).

Public-private partnerships have emerged as a strategic avenue to address underserved populations, resulting in insurance programs tailored specifically for these segments. Innovative ways of promoting insurance, such as incentive-driven programs that offer discounts or cashback rewards, increase the marketability of products.

The ongoing trend of innovation and digitization within the Malaysian insurance industry aligns with global advancements, where businesses play a pivotal role by introducing digital solutions for consumer engagement, claims processing, and insurance distribution. These solutions are catered to tackle the underinsured who actually look for uniqueness in products with digital-savvy components that make it easy for them to look for information. This includes real-time updates, automation in claims processing, and simple accessibility to the product platform (PwC, 2023).

However, the Malaysian insurance sector is not without its challenges. Escalating competition, evolving regulatory standards, and the imperative to raise awareness regarding the value of insurance among the general populace pose ongoing hurdles. Additionally, adapting to shifting consumer preferences and expectations remains a critical consideration.

1.3 The Concept of Takaful and Conventional Insurance

1.3.1 Concept of Takaful

The ancient Arab tribes' Al-Aqilah practice, which dates back to before 570 CE, is the origin of the notion of takaful, or Islamic insurance (Hachemi et al., 2014). In Al-Aqilah, tribal members made monetary contributions to recompense the victim's heirs in the event of an untimely death. The principle was accepted by Prophet Muhammad (PBUH) and became part of Islamic law. But takaful, which means "joint guarantee" in Arabic, is an agreement between parties to collectively guarantee against losses, in line with the values of collaboration and mutual aid that are highlighted in the Quran and Sunnah.

Four parties are engaged in takaful transactions: beneficiaries, insured persons, operators, and participants. Participants contribute to a mutual fund, and the fund provides support to covered persons who face hazards. Under Shariah guidelines, the takaful operator oversees the fund to protect against unforeseen losses. Incorporating the idea of *tabarru'* (giving) enables members to fulfill their mutual aid commitments. Takaful is based on cooperative and shared responsibility paradigms such as *al-Mudarabah* and *al-Wakalah*.

Under the *Mudarabah* model, participants face losses as capital suppliers while the takaful operator acts as an entrepreneur, splitting profits with them. Prudential guidelines protect the interests of participants. Under the *Wakalah* model, the operator manages participant money and receives a fee for acting as an agent.

However, based on shariah, takaful transactions must not contain any of the forbidden things, like *riba* (usury), *gharar* (uncertainty), or *maysir* (gambling) (Eldaia

et al., 2020). Strict prohibitions against *riba* emphasize that money should only come from legal sources. *Gharar* and *maysir* are connected, and the goal of *takaful* is to minimize return uncertainty. *Gharar* is defined as taking unwarranted risks, and it is forbidden to guarantee that investment benefits and losses are distributed equitably.

Unlike conventional insurance, *takaful* is designed to provide protection and indemnification in compliance with Islamic contract law. The concept emphasizes solidarity and collaboration across all parties (Hassan & Salman, 2017), which is consistent with the Hadith, highlighting that helping others as a means of obtaining assistance from Allah.

To sum up, *Takaful* is an alternative to conventional insurance since it is based on Islamic ideas of collaboration, mutual aid, and adherence to Shariah. The objective is to provide financial security while maintaining ethical and equitable practices in risk-sharing and management (Hachemi et al., 2014).

1.3.2 Concept of Conventional Insurance

The concept of insurance involves the systematic transfer of risk from individuals, organizations, or companies to an insurance entity, typically in exchange for a predetermined premium payment. This pragmatic approach serves as a method for effectively managing major pure risks. Within this framework, the insurance company, known as the insurer, assumes the responsibility of providing coverage. At the same time, the insured or policyholder commits to paying a premium at the initiation of the contractual agreement. In the unfortunate event of a loss, the insurer is obligated to indemnify the insured, providing what is termed as the insurance benefit.

From an economic standpoint, insurance functions as an institution rooted in the reciprocity principle established to create a general fund. Its necessity becomes apparent when unexpected risks materialize and the probability of such risks can be reasonably estimated. Defined in financial terms, insurance entails the redistribution of the costs associated with unforeseen losses.

Md. Saad et al. (2006) reticulate insurance as a collective endeavor, forming alliances for mutual cooperation and responsibility. This financial arrangement involves individuals substituting a nominal premium for protection against a potentially substantial and uncertain financial loss.

Fundamentally, insurance is an arrangement wherein an insured individual procures a plan that encompasses specified risks and losses. Premium payments are made in consideration for the provision of insurance protection, constituting a contractual commitment by the insurer to compensate the insured or their designated beneficiary in the event of a loss. Three pivotal characteristics define insurance arrangements: risk transfer, risk reduction, and loss sharing.

First off, a key component that is considered one of the most important parts of insurance is risk transfer, which makes it easier for the insured to shift their risk to the insurer with stronger finances. Second, effective risk mitigation is made possible by the insurer's capacity to forecast future losses with a reasonable degree of accuracy. Finally, the fair distribution of losses suffered by a few throughout the whole insurance pool is the last component of the loss-sharing principle.

An important component of the insurance contract is the Insurable interest that mandates the insurance buyer to possess a vested interest in the property or lives insured, ensuring a tangible financial loss to the buyer in the case of damage or loss.

Full and absolute trust in insurance contracts is contingent upon good faith, necessitating the insured to disclose all material facts during the policy purchase. The principle of indemnity involves the reimbursement of losses in various forms, such as cash, goods, or the cost of damaged property. It encompasses notions such as contribution, subrogation, and the doctrine of proximate cause. While these terms are initiated under the conventional insurance basic principles, they are also applicable in the takaful as long as they are aligned with Shariah principles, that is, avoiding the three elements mentioned earlier (Md. Nor, Mahdzir and Mohamad, 2020)

In summary, insurance operates as an economic mechanism facilitating the systematic transfer of risk among individuals. It enables the prediction and payment of losses from a fund contributed by all members of the insured group, thereby redistributing the costs of losses through premium payments. This arrangement encompasses the assurance of compensation in the event of covered losses, emphasizing the collaborative nature of risk management within the insurance framework (Hachemi et al., 2014).

1.3.3 Performance of Conventional and Takaful Sector

It is undeniable that the conventional insurance sector has far more experience compared to the takaful sector. Overall, in terms of its size, the takaful industry is only about 29% of the conventional counterpart from the life/family takaful perspective (Hazim, 2023). The performance of life insurance can be seen rising steadily after COVID-19, where its premiums rose from RM 11.4 billion in 2020 to RM 12.8 billion in 2021 (Life Insurance Association of Malaysia, 2021).

For takaful operators, the family takaful gross contributions increased from RM8.5 billion to RM10.06 billion in 2022 from 2021, which shows quite a steady

growth which the Malaysian takaful Association (MTA) said to be driven by strong market demands for Islamic finance products (Hazim, 2023). According to The Malaysian Reserve, the takaful sector has recently continued growing at a faster pace compared to the conventional sector, where its compound annual growth rate (CAGR) was at 20.6% in 2022. This figure actually outperformed the conventional counterpart with a CAGR of 10.8% in the same year. This is also said to be due to the growing demand for Islamic finance products in recent years.

In terms of profitability, however, both life and family takaful experienced some decline in the second half of 2023 due to the larger underwriting losses as a result of higher payments of medical claims (Qi, 2024). On the other hand, for general insurance and takaful, the profits came in higher, which was contributed by higher underwriting profits. In summary, Bank Negara Malaysia states that overall, the industry remains at a healthy level for its capital adequacy ratio, which is above the minimum regulatory requirement although still lower than that of June 2023 (Qi, 2024).

1.4 Problem Statement

In the year 2022, the penetration rate for conventional life insurance in Malaysia stood at 54%, denoting that 54% of the populace availed themselves of this particular coverage. Conversely, the penetration rate for family takaful, an Islamic variant of insurance, amounted to 19%, signifying that 19% of the population secured coverage through this avenue. These statistics elucidate that conventional Life Insurance exhibits a superior penetration rate relative to family takaful within the Malaysian context for the year 2022. Both penetration rates fall short of the 75% benchmark established by Bank Negara Malaysia in 2017, underscoring the latent potential for an augmented expansion of insurance coverage throughout the nation (PwC, 2023).

Despite the less-than-targeted penetration rates, the performance of both sectors remained stable based on the number of new businesses (Qi, 2024). The performance in terms of profitability, however, has decreased in 2023, as mentioned earlier, which is much due to the higher underwriting losses experienced in recent years. Some of the factors that could contribute to the profitability of the insurance sector could be company-specific components and macroeconomic aspects of the financial market, including inflation, Gross Domestic Product (GDP), and volatile market conditions. It is therefore, crucial to provide an understanding of the performance of the insurance and takaful sector, as this outlook is important for every stakeholder involved (Alithya, 2022).

The research problem under consideration holds paramount significance within the Malaysian context for a multitude of compelling reasons. Foremost among these is Malaysia's substantial Muslim population, for whom takaful insurance aligns meticulously with the principles of Islamic finance. Therefore, it is crucial to thoroughly comprehend and analyze the relative performance of takaful in comparison to conventional insurance in order to effectively meet the financial requirements of this specific population.

Moreover, Malaysia has said quite clearly that it wants to become known around the world as a center for Islamic finance. This vision is intrinsically tied to takaful's effectiveness and success. Consequently, the assessment of the takaful's performance bears significant consequences for Malaysia's status and reputation within the global Islamic financial environment (Salehuddin & Suhaidi, 2024).

Despite the availability of both conventional insurance and takaful, an analysis of market dynamics indicates a noticeable imbalance in market share (Md Husin, 2019).

There is hope that examining the fundamental causes of this discrepancy will lead to increased market competition and more options for customers.

On the other hand, Malaysia has been trying to develop financial services that adhere to Shariah, with a focus on takaful, where assessing the financial performance of takaful firms is crucial in determining the efficacy of these regulatory initiatives and their wider implications for the sector.

Various studies have looked into empirical analysis to analyze the factors that actually contribute to the performance of insurance and takaful companies, where performance is measured by the profitability of companies, either utilizing the use of return on assets (ROA) or return on equity (ROE). There seems to be limited literature that focuses on comparing the data by the company since data on the insurance and takaful sector requires collecting data through the annual reports of each company. A study by Sahudin et al. (2022) focused on the performance of takaful operators utilizing panel data regression and found that factors such as the size of the firm, GDP, and liquidity have a significant relationship with the financial performance of the companies. The study by Sahudin et al. (2022) did not include conventional insurers as part of the study and excluded certain variables such as solvency, underwriting performance, and operating efficiency.

Another research by Abdul Aziz (2019) also applied panel data regression. Still, it included variables such as Gross Domestic Product (GDP), Base Lending Rate (BLR), and Treasury Bills Rate (TBR) for the macroeconomic factors and underwriting risk, expense ratio, and size of the company as the firm-specific factors. Other studies, such as those by Hamdan (2018), used variables such as underwriting performance, solvency,

liquidity, and operating efficiency as factors that could contribute to the profitability of insurance and takaful companies.

In light of all of the discussion above, this study aims to contribute to current knowledge by conducting a thorough examination of the financial performance metrics comparing Malaysian takaful and conventional insurance companies. This analysis encompasses components such as solvency, liquidity, profitability, underwriting efficacy, and operational efficiency. This is similar to the study by Hamdan (2018) but different in terms of the methodology applied to achieving its objectives. In undertaking this endeavor, the research aspires to provide invaluable insights to a diverse spectrum of stakeholders, encompassing regulatory bodies, investors, industry practitioners, and other stakeholders with vested interests. Ultimately, this research contributes substantively to a more profound comprehension of the evolution and progress of the insurance sector within Malaysia.

1.5 Research Questions

1. How do the (solvency ratios, liquidity ratios, profitability ratios, efficiency ratios, and underwriting performance) metrics of takaful insurance companies compare to those of conventional insurance companies in the Malaysian insurance industry?
2. What is the nature and strength of the relationship between the independent variables (solvency ratio, liquidity (financial performance) in both takaful and conventional insurance companies operating in the ratio, efficiency ratio, and underwriting performance) and the dependent variable profitability ratio in the Malaysian insurance industry?

1.6 Research Objectives

1. To compare the solvency ratio, liquidity ratio, profitability ratio, efficiency ratio, and underwriting performance of takaful and conventional insurance.
2. To examine the relationship between independent variables (solvency ratio, liquidity ratio, efficiency ratio, and underwriting performance) and dependent variables (financial performance) in takaful and Conventional Insurance

1.7 Significance of the Study

This study has broad ramifications for many different areas and provides a number of advantages. The aim is to furnish policymakers and business leaders with significant perspectives, empowering them to formulate strategic choices that are suited to the advantages and disadvantages of certain sectors within the insurance industry, particularly in the conventional and takaful insurance sectors. The study encourages healthy competition among insurance firms by exposing subtle financial inequalities, which eventually results in ongoing improvement and benefits for consumers.

Gaining an in-depth understanding of the financial status of both conventional and takaful insurance companies helps investors make wise investment choices. Furthermore, it offers a strong dataset to investigate the variables affecting insurance businesses' financial success.

The results of the study may be utilized by policymakers to build strategies that support a competitive and well-balanced insurance sector. This sector is crucial for maintaining economic stability and growth, ultimately contributing to Malaysia's total economic growth.

Furthermore, it raises awareness among stakeholders, including consumers, regarding the financial strength and capabilities of takaful and conventional insurance providers. This heightened awareness empowers stakeholders to make more informed choices when it comes to insurance services.

In essence, this study transcends mere numerical comparisons, reshaping the insurance landscape by promoting competition, informed decision-making, economic growth, and ethical financial practices.

1.8 Scope of the Study

The scope of the study is centered on Malaysia's insurance industry (takaful & conventional insurance), where a selection of ten companies, five of them are takaful companies, and the other five are conventional insurance companies. It focuses on takaful and conventional insurance firms within the country, analyzing their financial performance from 2016 to 2021. The study employs quantitative research methods to compare key financial ratios, including solvency, liquidity, profitability, underwriting efficiency, and operational effectiveness. The analysis aims to identify statistically significant differences in these aspects between the two insurance systems. The research acknowledges potential limitations, and the findings contribute to a nuanced understanding of the industry's evolution and dynamics.

1.9 Organization of the Study

The organizational framework of the study follows a logical progression, beginning with a comprehensive literature review in Chapter Two, where relevant literature on takaful, conventional insurance, and financial performance analysis is explored. Chapter Three elaborates on the research methodology, Chapter Four

elaborates on the preliminary results, and Chapter Five mentions the conclusion and recommendation.

