From Faculty's Table

VBIT and VBI: A Long-term Response to Sustainable Takaful?

The sustainability agenda has increased in prominence as climate change wreaks havoc across vulnerable areas globally. Over the last two decades, the substantial increase in weather-related events, human displacement, and loss due to conflict and contagion have nudged global leaders to drive more sustainable policies for a better world. Financial institutions, as funders of the largest contributor to climate change, the industrial complex, have also been required to adopt sustainable policies through several responsible, ethical or Environmental, Social, and Governance (ESG) frameworks such as 6 United Nations Principle for Responsible Investment (PRI), 17 United Nations Sustainable Development Goals (SDGs), etc. The significant cost of damages has been increasing exponentially.

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For example, by the end of 2020, global damages resulting from climate disaster was estimated at approximately USD210 billion, with USD82 billion insured losses (Munich Re, 2020). By March 2021, losses from unusual or extreme temperatures in the state of Texas in the US alone had already resulted in USD30 billion worth of damages. General and life insurers are most impacted as they are expected to provide a 'financial first response' coverage in disaster events.

Insurance institutions that underwrite this damage have a direct role in reducing the impact of climate change if they intend to be sustainable over the long term. If insurance companies resort to typical pricing measures to ensure profitability like higher premiums, smaller payouts and additional exclusions, products will become inaccessible to those that are most in need of such protection. Takaful operators provide similar services and are exposed to ever-increasing payouts as the effects of climate change and other human catastrophes increase. What then is the long-term response to ensure the sustainability of insurance and takaful companies?

An insurance sustainability movement has been gaining momentum internationally, with Europe leading the charge. The United Nations Environment Programme Finance Initiative (UNEP FI) established sustainability principles and launched them in June 2012 to motivate a transformation and an integration of sustainability principles within the global insurance industry. The UNEP FI Principles for Sustainable Insurance (PSI) initiatives focus on building a strategic approach to activities within the insurance value chain by ensuring that interactions with stakeholders are responsible and forward-looking.

The objectives also include monitoring risks and opportunities associated with environmental, social and governance issues. Through four comprehensive principles, the global insurance, and by extension, the takaful industry is expected to embed ESG issues within company strategy, risk management, product development, and investment management.

As conventional finance regulators began releasing benchmarks, guidelines, rating methods, and disclosure frameworks for sustainability, Islamic finance regulators also contributed through their own initiative. Bank Negara Malaysia (BNM), in collaboration with members of the 'Community of Practitioners' consisting of representatives from nine Islamic banking institutions in Malaysia, and working closely with INCEIF, released a strategy paper in 2017 on Value-based Intermediation (VBI), a sustainable finance approach based on Islamic precepts. This covered the financial intermediaries but not insurance or takaful operators. As part of a holistic approach to realign the finance industry towards sustainability and responsibility, the Malaysian takaful operators were tasked with drafting a similar strategy paper that would relate more directly to their sector. The Value-based Intermediation for Takaful (VBIT) was released in mid-2021 to fill this gap. However, has the VBIT adequately aligned toward the ideals of objectives of Shariah (*maqasid al-Shariah*) and social impact? Furthermore, how does the strategy paper compare to the VBI framework it was meant to be modelled upon? And has it sufficiently integrated the PSI principles as a more unified response? We briefly assess the facts.

VBI initiatives build upon the five protections of the maqasid al-Shariah (faith, life, wealth, lineage, and intellect) in determining its values and priorities.

VALUE-BASED INTERMEDIATION (VBI)

Islamic banking has often been criticised for focusing on legal compliance rather than sustainability or socio-economic empowerment for societal sectors that are most in need. Islamic banks are therefore expected to move toward more responsible financing and intermediation that create social impact beyond traditional corporate social responsibility. This requires Islamic banks to effectively incorporate the *maqasid al-Shariah* through meaningful metrics and disclosure.

The VBI concept is defined as an

> *intermediation function that aims to deliver the intended outcomes of Shariah through practices, conduct and offerings that generate positive and sustainable impact to the economy, community and environment, consistent with the shareholders' sustainable returns and long-term interests.*

VBI thus encourages **all** financial intermediaries (not only Islamic) to integrate responsible and sustainable practice through a more focused **corporate value intent** that includes wider stakeholder inclusion and a broader community-centric impact. VBI shares several similar characteristics with other socially responsible strategies led by ESG, Sustainable and Responsible Investment (SRI) and Corporate and Social Responsibility (CSR).

However, VBI initiatives build upon the five protections of the *maqasid al-Shariah* (faith, life, wealth, lineage, and intellect) in determining its values and priorities. The focus is to integrate responsible practice within business activities as a source of competitive advantage and best practice. VBI differs from earlier practices of a CSR cost centre, often confined to limited philanthropic activities based on predetermined budgets (with costs often set off with gains in public relations). VBI, on the other hand, seeks to disrupt the single profit maximisation objective through a more harmonious triple bottom line (3BL) that prioritises people, planet and profit. The four key drivers of VBI focus on encouraging an entrepreneurial mindset; empowering communities through financial solutions that create a positive impact; instituting a culture of accountability or good self-governance; and ensuring best conduct in interaction with all stakeholders.

Since the release of the strategy paper and the subsequent Value-based Intermediation Financing and Investment Impact Assessment Framework (VBIAF) to establish clear measurables for integration, several Malaysian banks have embraced the concept, and some have even revised their vision and mission.

For example, the first Islamic bank in Malaysia, Bank Islam Malaysia Berhad (Bank Islam), changed its vision from: 'To be a global leader in Islamic banking' (BIMB, 2016) to 'The bank that advances prosperity for all' (BIMB, 2021).

Criticisms exist. For instance, is Islamic banking attempting to become more publicly acceptable through an elaborate marketing exercise through a friendly VBI approach that markets transparency and socio-economic empowerment? Can the *maqasid* be measurable within a corporate setting, or are they subjective pillars of upholding the underlying reasoning of justice and fairness that the Shariah espouses? Criticisms aside, a move towards doing good is envisaged to create a positive impact over the long term and should be supported as it evolves into more substantial change.

UNEP FI PRINCIPLES FOR SUSTAINABLE INSURANCE (PSI)

The historic Rio Earth Summit of 1992 was the catalyst for the development of sustainability principles, including the PSI, launched at the Rio+20 Summit in June 2012. Insurance institutions aligning to the PSI have been committed to integrating ESG into their operations and raising awareness of ESG issues whilst developing more sustainable products.

Sustainable insurance is defined by the PSI as:

> *a strategic approach where all activities in the insurance value chain, including interactions with stakeholders, are done in a responsible and forward-looking way by identifying, assessing, managing and monitoring risks and opportunities associated with environmental, social and governance issues. Sustainable insurance aims to reduce risk, develop innovative solutions, improve business performance, and contribute to environmental, social and economic sustainability.*

Based on four core principles, the PSI emphasise on the importance of disclosure, transparency and accountability to stakeholders to enhance credibility and build trust. The principles are brief and provide suggested actions to achieve the core objectives, as depicted in Figure 1.

Figure 1: Four Core Principles for Sustainable Insurance (PSI)
Source: https://www.unepfi.org/psi/the-principles/

Several successful examples of implementation have positively impacted the sustainability movement

Being purely aspirational and voluntary, profit-driven insurance institutions are expected to be incentivised by the willingness to do good. Each principle includes possible actions including embedding ESG within company strategy, board of directors (BOD) awareness, selling techniques, and investment management (Principle 1); raising ESG awareness with suppliers, customers and reinsurers (Principle 2); promoting and supporting ESG regulation, social institution ESG discussion, and public awareness on ESG (Principle 3); and assessing, measuring, disclosing and monitoring company progress on ESG issues (Principle 4).

Several successful examples of implementation have positively impacted the sustainability movement. For instance, signatories including Munich Re and Swiss Re disclose in their corporate responsibility reports that beyond integrating ESG into its various operational and executive levels, they apply a group-wide ban on insuring or investing in banned weapons manufacturers, restricted coverage on new coal-fired power plants or coal mines, discontinued coverage for individual risks of oil sands mining projects and infrastructure. Many insurers are signatories to other internationally recognised ethical frameworks as well, including the UN Global Compact; Universal Declaration of Human Rights; International Labour Organization (ILO) Declaration on Fundamental Principles and Rights at Work; Rio Declaration on Environment and Development; and the UN Convention against Corruption.

One key challenge is to ensure that signatories apply sustainability criteria without attempts of corporate 'greenwashing' (creating a false impression or providing misleading information that the company is responsible and environmentally friendly) through either false marketing or spin-doctoring of activities exaggerating their benefits. Closer scrutiny of disclosure and increased public awareness may reduce opportunities for communities to be hoodwinked into what we can call *green awe*.

VALUE-BASED INTERMEDIATION FOR TAKAFUL (VBIT)

Takaful penetration has always struggled to keep up with the growth of Islamic banking globally. For example, in Malaysia, the family takaful cumulative annual growth rate (CAGR) between 2013 and 2018 stood at 11%, which is higher compared to the conventional insurance CAGR (only 6% for the same period). However, the overall penetration rate remained low by the end of 2020 (approximately 15%) compared to Islamic banking (37%). A significant reason for this seems to be low awareness levels and the unfamiliarity with the differences between conventional insurance and takaful.

Driven by BNM through the Malaysian Takaful Association (MTA), the VBIT framework was released in June 2021, as detailed in Figure 2:

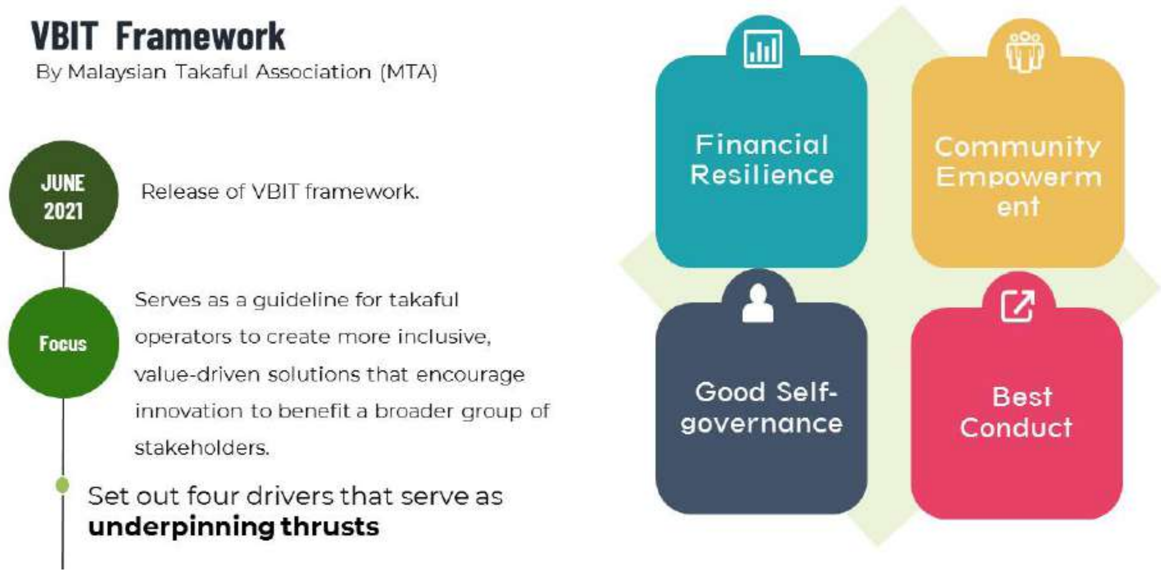

Figure 2: Value-based Intermediation for Takaful (VBIT) Framework
Source: Adapted from VBIT Framework (2021)

'Financial Resilience' is significant in addressing losses from climate change and other man-made catastrophes. Supporting victims of increasing natural disasters requires that financial safety nets are provided to ensure rapid recovery from such financial shocks. The framework suggests that takaful operators can develop societal financial resilience through more risk-specific products and offer more holistic risk management advisory services for better financial decision-making. However, the framework does not address the urgency of a broader ESG awareness for long-term sustainability. This could be because it may serve as complementing the PSI framework rather than intending to replace it.

A further assessment of the three remaining drivers shows that they focus on stakeholder engagement and increasing the takaful value proposition through good self-governance and conduct. The metrics used to determine successful takaful operators include higher customer satisfaction, a sustainable value-chain and the number of solutions offered to the underserved and unserved. Examples already exist in Malaysian practice, as evidenced in Figure 3:

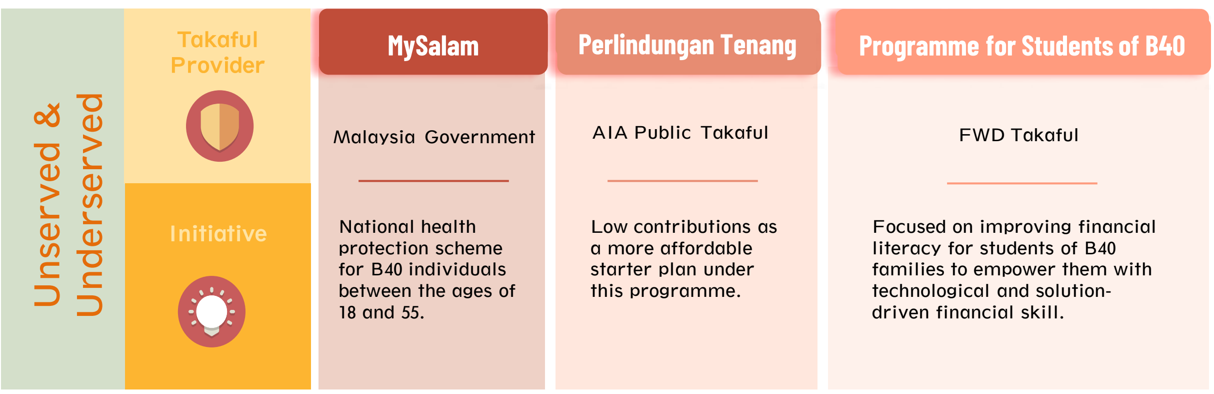

Figure 3: Examples of VBIT Initiatives in Malaysia
Source: Author's Own

Sustainability is no longer the realm of 'do-gooders' and tree huggers. It is all mankind's responsibility, as a matter of urgency.

VBIT implementation strategies suggest models from MNRB Holdings and Bank Islam. Bank Islam has articulated a clear sustainable, value-driven strategy in its Annual Report 2019, with a focus on social capital and inclusive growth. In line with the VBI model, VBIT suggests inclusive stakeholder engagement, value-driven solutions, impact-based assessments, and constructive collaboration to be integrated within takaful operator strategies over the long term. Impact-based assessment can provide a more objective and standardised rubric to disclose progress in sustainability initiatives, which may also motivate competitors. Easily implementable strategies may focus on ensuring that all investment placements of takaful operators are assessed for impact, or thresholds may be introduced for non-green rated investments to be limited to, for example, less than 30 per cent of all placements.

SUMMARY

Humanity's so-called 'Doomsday Clock' that represents the likelihood of man-made global catastrophe has never been closer to midnight than in 2021.

Sustainability is no longer the realm of 'do-gooders' and tree huggers. It is all mankind's responsibility, as a matter of urgency. Insurance and takaful operators provide financial protection to those who participate, but exposure to risk is increasing. Therefore, embracing and promoting sustainability criteria becomes a strategic decision for the sector to remain a going concern. PSI, VBI and now VBIT provide valuable guidelines for operators to recalibrate and offer more value-driven solutions through stakeholder engagement. If operators do not embrace these initiatives, customer activism may force their hand, if the climate doesn't first. VBIT is an encouraging framework that can be considered for replication in other Islamic finance jurisdictions, exhibiting takaful's contribution to the *maqasid* and socio-economic empowerment.

Evolving metrics will support the progress and allow for realignment to improve output. It's time for action.

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