Muslim integrity and retirement security

Messrs Danny Quant and **Safder Jaffer** of **Milliman** describe the issues that Muslims face in establishing financial security in old age, and offer a potential framework to overcome the hurdles under certain aspects of Shariah law.

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History tells us that the model of a state-funded pension among Muslims stretches back to the earliest times of the religion, under the second caliph Omar in the seventh century, when monies were set aside specifically to fund the retirements of certain groups. The practice continues today in many Islamic states, where civil servants and others enjoy retirement benefits based on their years of service.

But two separate forces are working today to undermine retirement security among many Muslims. The first is the population pressure that much of the world is experiencing, with life expectancy climbing and fertility rates falling. Within less than two decades, it is likely that the support ratio in many Islamic countries – that is, the ratio of people aged 15 to 64 to those aged 65 and older – will witness a steep drop, shrinking tax bases and making it increasingly difficult for governments to step in and fill the gap. That makes it more important than ever for individuals and private employers to recognise and accept their own responsibilities in this area, and begin programmes of personal savings.

In fact, under Shariah law, there is an argument to be made that this is a sacred responsibility. Under the guiding principles for the protection of life, family, and wealth, each individual has a solemn charge to make adequate preparations for retirement and for the care of themselves and those dependent on them. The best way to do that is finding a way to build a nest egg that will be there when they need it.

That leads us to the second force affecting retirement security among Muslims.

Challenges of Shariah

The conventional pension fund operating models we are familiar with from mature retirement markets are often not fit for the purpose under Shariah law. In Islam, one fundamental principle states that everything is allowed as long as there is no proof in sacred text that it is prohibited. But certain key elements of the conventional fund models are presently considered to be *haram* (forbidden).

Consider the annuity, a simple-enough device in conception. A lump sum of money, usually the result of a lifetime of saving, is used to purchase an annuity, which then pays out a monthly sum for the lifetime of the beneficiary. The monthly sum is determined by actuarial calculations based on attributes of the annuity purchaser such as age. Annuities tend to lock in earnings from investment instruments and provide dependable income streams, protecting retirees from volatility in their later years that could possibly even leave them impoverished and unemployable.

Many takaful operators can accommodate pensioners who prefer to receive a lump sum benefit on retirement. But purchasing annuities quickly poses at least three tricky areas in terms of compliance with Shariah law:

- *Riba* (interest): Interest (also known as “usury”) is considered to be prohibited altogether under Shariah law except in cases of necessity. If the income received by a retiree from an annuity exceeds the amount paid to purchase it, that would be considered *riba*, which is prohibited.

- *Gharar* (uncertainty): People purchasing annuities generally do not know how much longer they will live (known as "longevity risk"), nor do they necessarily understand the details of the exchange. Under Shariah law, many argue that either or both of these factors represent *gharar*, or uncertainty, which is prohibited.
- *Maysir* (gambling): Longevity risk also introduces a level of risk that could make purchase of an annuity a form of maysir, or gambling, in some interpretations, as in essence you are betting on your own ability to live longer while the issuer of the annuity is betting on your early death. *Maysir*, or gambling, is strictly prohibited.

Within the conventional retirement models, there are still more issues of Shariah compliance. They may be related to broad areas such as inheritance and divorce. They may be highly particular as in the case of *zakat*, a form of levy usually at the rate of 2.5% per annum based on the ownership of certain types and net quantities of asset, which is due after possession for one lunar year. Or they may be practical, as in the need to develop long-term Islamic investment instruments.

Shariah-compliant alternatives

The good news is that, even with due attention to the sensitivities behind Shariah prohibitions, there are ways to address many of the challenges. The financial services industry, for example, working in concert with Shariah authorities, has essentially overcome many of the problems associated with riba by transferring the concept of interest to profits – that is, profits are earned on investments rather than interest. Indeed, a working system compliant with Shariah law is coming into place for the accumulation phase of retirement plans, enabling money saved now to enjoy growth and earnings in the future.

But the prohibitions against annuities, arguably the safest way to preserve a lifetime's savings across one's retirement, is the fine focus of the problem now. A part of this problem under Shariah law, the *maysir* (gambling) prohibition, may find some solution in innovations that have been developed (and are still developing) within the takaful industry to accommodate a Shariah-compliant form of life insurance. But there is the further problem with an annuity, associated with *riba*, of how the actual payouts are structured.

A promising solution in the Shariah investment world may be found in the ongoing development of long-term sovereign *sukuk*, which for all intents and purposes are bonds. It is possible, for example, that a series of sukuk could be cash flow-matched to a population that has purchased an annuity. It would essentially be a longevity bond, but structured within Shariah law.

One more issue to consider is the question of whether or not it is haram to encourage somebody to get involved with something they do not understand. If a person does not understand the product they have purchased – in this case, an annuity with timed payments – well enough to repeat it and make another understand, that person could be cheated, which is a problem of *gharar*.

A new special purpose financial vehicle

Milliman has proposed that Shariah authorities approve the creation of a special-purpose financial vehicle that can be used to support retirement products of takaful and insurance companies. It addresses all the concerns of Shariah law we have discussed in terms of an annuity: *riba*, *gharar*, *maysir*, and others as well (including issues related to *zakat*). This financial instrument would essentially separate out the various components in the whole transaction. In many ways, it looks like a trust arrangement, but there is sufficient legal separation among the various parties to satisfy requirements of Shariah law.

There is still a need for *sukuk* at longer periods. There is little or no availability for *sukuk* with tenors longer than 20 years. A possible solution here could be wrapping *sukuk* around infrastructure projects such as toll roads or airports, whose income streams would then serve as proxy for payments due. In many ways, it is a matter now of what countries will be willing to step up and do it, likely one of the more moderate and stable states such as Malaysia or Indonesia, some countries in north Africa, and possibly Saudi Arabia.

Longer-term *sukuk* could play a vital role in an operating model. Participants would place their savings via an *uqud al-Tabarru'at* (contract of donation) into a designated pension pot, implemented via a legally binding *wa'ad iltizami* (self-imposed promise). These savings are intended to cover the family in case of the premature death of the participant and could eliminate issues related to inheritance. Perhaps most importantly, as a unilateral contract it would not attract *riba*, *gharar*, or *maysir*.

To help manage the longevity risk, the *wakeel* (an agent who manages fund investments) or *mudharib* (a person who partners with a contributor of capital in a profit-sharing venture) could invest in longevity-hedging investment instruments such as long-term infrastructure projects. This would be combined with a de-risking strategy as the participant cohort matures toward retirement age in order to ensure there is enough cash to sustain the annuitants.

Upon retirement, participants would receive monthly income from a long-term *sukuk*. Alternatively – or at the time of maturity of the *sukuk* – participants could approach a takaful company to help them achieve a steady monthly income. This could be done either by investing in a product with a drawdown mechanism similar to a pension or by an arrangement to provide a monthly income for a fixed period, or even by the takaful company making a *wa'ad iltizami*, a commitment to look after the annuitant for a certain number of years.

A need for a workable framework

To be clear, most of these thoughts are simply theoretical models now under discussion in the takaful community but not yet implemented. There is an unmistakable need in many Islamic societies for greater private pension provision. The non-applicability of annuities and conventional bonds, along with other special considerations, make this a complex landscape indeed. Meanwhile, it is clear there is a need and role for actuaries in contributing to developing a workable framework of Shariah-compliant pension saving.

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