



ISLAMIC FINANCIAL SERVICES BOARD

IFSB-20

KEY ELEMENTS IN THE SUPERVISORY REVIEW PROCESS OF *TAKĀFUL/RETAKĀFUL* UNDERTAKINGS

DECEMBER 2018

ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include the banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a stringent due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which includes holding several Working Group meetings, issuing exposure drafts and organising public hearings/webinars and reviews by the IFSB's Sharī'ah Board and Technical Committee. The IFSB also conducts research and coordinates initiatives on industry-related issues and organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

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ABBREVIATIONS

BOD	Board of Directors
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principles
IFSB	Islamic Financial Services Board
JWG	Joint Working Group
ORSA	Own Risk and Solvency Assessment
PCR	Prescribed Capital Requirement
PIF	Participants' Investment Fund
PRF	Participants' Risk Fund
RSA	Regulatory and Supervisory Authority
RTO	<i>Retakāful</i> Operator
RTU	<i>Retakāful</i> Undertaking
SHF	Shareholders' Fund
TO	<i>Takāful</i> Operator
TU	<i>Takāful</i> Undertaking

Bismillahirrahmanirrahim.

Allahumma salli wasallim `ala Sayyidina Muhammad wa`ala `alihi wasahbihi

SECTION 1: INTRODUCTION

1.1 Background

1. The Islamic Financial Services Board (IFSB), in promoting the development of a prudent and transparent Islamic financial services industry through introducing new and/or adopting existing international standards that are not in conflict with Shari'ah rules and principles, plays an active and complementary role to that of the International Association of Insurance Supervisors (IAIS) by issuing prudential and supervisory standards for *takāful/retakāful* in order to promote the soundness and stability of the financial system as a whole and to safeguard the interests of consumers. This Standard is based on recommendations made in the paper titled "Issues in Regulation and Supervision of *Takāful* (Islamic Insurance)", produced by the joint working group (JWG) established by the IFSB and the IAIS in 2005.

2. The JWG paper outlined four major themes for dealing with the regulatory issues associated with the *takāful/retakāful* industry. These themes, which have thus far guided the IFSB in developing standards and guiding principles for the industry, are as follows:

- corporate governance;
- financial and prudential regulation;
- transparency, reporting and market conduct; and
- supervisory review process.

3. On the basis of the four identified themes, four standards and one guidance note specific to *takāful* have been adopted by the IFSB Council:

- IFSB-8: *Guiding Principles on Governance for Takāful (Islamic Insurance) Undertakings* [December 2009];
- IFSB-11: *Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings* [December 2010];

- GN-5: *Guidance Note on the Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on Takāful and Retakāful Undertakings* [March 2011];
- IFSB-14: *Standard on Risk Management for Takāful (Islamic Insurance) Undertakings* [December 2013]; and
- IFSB-18: *Guiding Principles for Retakāful (Islamic Reinsurance)* [April 2016].

4. Other standards published by the IFSB applicable to Islamic financial institutions generally – namely, IFSB-9: *Guiding Principles on Conduct of Business for Institutions Offering Islamic Financial Services* and IFSB-10: *Guiding Principles on Sharī'ah Governance Systems for Institutions Offering Islamic Financial Services* – provide guidance in the areas of conduct of business and Sharī'ah governance relevant to *takāful*.

5. In the standards that have been issued for *takāful* thus far – that is, IFSB-8, IFSB-9, IFSB-10, IFSB-11, IFSB-14 and IFSB-18 – the principal focus has been on the requirements to be applied to *takāful* and *retakāful* undertakings (TUs/RTUs) and operators (TOs/RTOs),¹ rather than on the actions of the regulatory and supervisory authorities (RSAs) responsible for overseeing the *takāful* and *retakāful* sector. However, various sections in these standards emphasise the importance of having in place an effective supervisory review process. In IFSB-8, paragraph 79 states: “Besides good governance, other areas that the IFSB may address through appropriate standards and guidelines on best practices for the *takāful/retakāful* industry include solvency, financial and prudential regulation, transparency and disclosure, conduct of business and supervisory review process.” In IFSB-11, Key Feature 6 mentions the need to ensure adequate supervisory assessment of risk management arrangements of *takāful* operators. In IFSB-14, Section D of the document outlines “Key Elements in the Supervisory Review Process of Risk Management for *Takāful* Undertakings”. Finally, in IFSB-18, Principle 5.1 provides guidance on “Supervision of *Retakāful*/Reinsurance Programmes”.

6. This standard describes and consolidates key elements of the supervisory review process. The goal of the standard is to assist RSAs to develop an integrated system for assessing the governance framework, capital adequacy, risk management framework and *retakāful* programmes of TUs/RTUs, as highlighted and recommended in IFSB-8, IFSB-11, IFSB-14 and IFSB-18, as well as other matters relevant to all areas of supervision, with a particular focus on those areas specific to Islamic finance.

¹ Like other IFSB standards, this standard distinguishes between the TU/RTU as a whole, including the participants' interests, and the TO/RTO operating the undertaking. Provisions in the text refer to the TU/RTU or TO/RTO as applicable.

1.2 Main Objectives

7. This standard is primarily intended to guide the firm-level supervision of TUs/RTUs. It aims to provide guidance and support for the implementation of common approaches to the supervision of the *takāful* and *retakāful* industry, while addressing the specificities of these institutions. This is to protect the interests of the contracting parties in the *takāful/retakāful* undertaking and the long-term stability of the *takāful* system.

8. The standard is developed around the following objectives:

- a. to provide guidance to supervisors on minimum standards for an effective and efficient supervisory review process for TUs and RTUs, addressing the unique elements of these institutions;
- b. to promote, by means of supervisory review, fair, safe and stable *takāful* and *retakāful* markets for the benefit and protection of participants;² and
- c. to promote harmonisation of supervision internationally, and hence to enhance cooperation among supervisors.

1.3 Principles

9. While this standard is the first comprehensive supervisory review process initiative for the *takāful* and *retakāful* industry, it is not the first of its kind in the work of the IFSB. Two documents on the supervisory review process have been issued previously (IFSB-5³ and IFSB-16⁴) to address issues pertaining to the supervisory review process of the Islamic banking industry.

10. Following the approach taken by the IFSB's Articles of Agreement, this document sets out principles for regulatory supervision to be applied by the RSAs to the *takāful/retakāful* industry, in parallel with perspectives set out by the IAIS, in order to provide for effective supervision of the industry, consistent in quality with that applicable to the conventional insurance industry, subject always to the requirements of Sharī'ah principles. So far as

² "Participant" means the party entering into a *takāful* contract with a TU to obtain cover. (The term "policyholder" is also commonly used in the market and has been used in previous IFSB standards.) The term "participant" may also have other meanings in different contexts related to *takāful*.

³ IFSB-5: *Guidance on Key Elements in the Supervisory Review Process of Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (Takāful) Institutions and Islamic Mutual Funds)*.

⁴ IFSB-16: *Revised Guidance on Key Elements in the Supervisory Review Process of Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (Takāful) Institutions and Islamic Collective Investment Schemes)*.

features of regulatory supervision that are in common with conventional insurance are concerned, users of this standard should have regard to the Insurance Core Principles (ICPs)⁵ and other standards issued by the IAIS. Where relevant, this document makes reference to those standards. The central focus of this standard is on the specific characteristics of TUs and RTUs, and on the manner in which the supervisory review process of RSAs addresses those specific characteristics.

11. This standard has been designed to set out principles that RSAs may apply to a variety of circumstances, and not to prescribe specific quantitative standards. For example, it does not specify how often an on-site inspection should be conducted, recommend a particular format of regulatory returns, or specify the relative weighting that RSAs should place on particular characteristics of TUs/RTUs when making decisions on supervisory activity. Other IFSB standards, including IFSB-8, IFSB-9, IFSB-10, IFSB-11, IFSB-14 and IFSB-18, should also be referred to in understanding and applying the contents of this standard.

12. The standard should be applied with due consideration to “proportionality”, taking account of the size, nature and complexity of each institution and the characteristics of the environment in which it operates, as these will differ from institution to institution and from jurisdiction to jurisdiction. In particular, careful thought should be given when applying it to *microtakāful*. In this area, the joint IFSB–IAIS paper issued in November 2015, *Issues in Regulation and Supervision of Microtakāful (Islamic Microinsurance)*, gives helpful perspectives.

1.4 Scope and Application

13. This standard is intended to guide the supervision of TUs and RTUs operating under family *takāful/retakāful*, general *takāful/retakāful* or composite *takāful/retakāful* licences. RSAs may extend the applicability of the standard to *takāful/retakāful* “window” operations that fall within their jurisdictions. The issue of windows is discussed specifically in section 3.7.

14. This standard focuses primarily on supervision of *takāful/retakāful* at the level of the individual entity. Where an RSA is responsible for supervision of a group containing *takāful/retakāful* operations, it may apply the principles when carrying out supervision at the level of the group, as well as when supervising individual undertakings. To apply the principles at the level of the group, some modification may be necessary for practical reasons. Some issues in group supervision are discussed in section 4.1.

⁵ In particular, ICPs 9, 10, 11 and 12.

15. Most *takāful/retakāful* undertakings operate on a so-called hybrid model between a mutual and a shareholder company. (See IFSB-8, paragraph 5, for a fuller discussion of this model.) This standard is written primarily around such structures. However, it is applicable with limited modifications to pure mutual models – as used, for example, in Sudan – and to the cooperative model used in Saudi Arabia.

SECTION 2: SUPERVISORY APPROACHES FOR EFFECTIVE SUPERVISION OF *TAKĀFUL/RETAKĀFUL*

16. This standard aims to ensure that the supervisory review process applied by RSAs to the *takāful/retakāful* industry will be generally consistent in quality and approach with that applied to conventional insurers/reinsurers and relevant to the current state of the industry, while catering for the specificities of Sharī'ah-compliant *takāful/retakāful* activities and promoting the financial soundness of the industry. The IFSB has taken note of developments in supervisory practices as applied by various RSAs, as well as pronouncements of other international standard-setting organisations, principally the IAIS.

17. The term “supervisory review process” refers to the criteria and tools by which an RSA carries out its supervision. It includes:

- a. the ways in which the RSA gains an understanding of the activities of regulated undertakings and the environment in which they are operating, with a view to identifying risks to which those undertakings and the market more generally are exposed, and assessing those undertakings' ability to manage and bear those risks. An example of a risk at market level might be climate change affecting the likelihood of extreme weather events. An example at enterprise level might be a strategic decision to enter a new area of business with specialised technical requirements;
- b. the RSA's processes for identification and assessment of threats to the functioning of the market, which may arise to the detriment of participants and beneficiaries, as well as other stakeholders (and which may identify a need for further regulation to be developed, or existing regulation to be modified because of unintended consequences). An example is a technological development that makes possible a new business model; and
- c. the RSA's processes for monitoring adherence to regulation to identify and address actual and potential non-compliance. An example of the former would be whether the enterprise meets the capital adequacy standards set for it; an example of the latter would be whether its compliance with those standards might be threatened by the failure of a *retakāful* undertaking on which it depends.

18. In the case of TUs/RTUs, relevant risks will include those of Shari'ah non-compliance. The responsibilities of RSAs in this area vary, as acknowledged by IFSB-10, but RSAs will

need to cover Shari'ah non-compliance risk within the processes described above, to the extent consistent with their responsibilities.

19. In identifying the supervisory review process, a distinction is drawn in this standard between regulation (setting the rules that regulated undertakings are required to adhere to)⁶ and supervision (the activity of the RSA in satisfying itself that its objectives are achieved). Many RSAs act also as regulators, but it is supervisory activity that is the focus of this standard. There is inevitably an overlap between the two concepts since, for example, the requirement to supply certain information to the supervisor may be embodied in regulation, but this standard is not primarily concerned with the behaviour required of TUs/RTUs.

2.1 Risk-based Approach

20. The RSAs' principal objective in supervising the *takāful/retakāful* industry is to promote the maintenance of fair, safe and stable *takāful/retakāful* markets for the benefit and protection of all stakeholders. In the case of *takāful/retakāful*, an important stakeholder interest is in Shari'ah compliance, and thus an important aspect of supervision involves ensuring that a claim to Shari'ah compliance is soundly based.

21. This standard advocates a risk-based approach to the process of supervising TUs and RTUs. For conventional insurance, the IAIS's Core Principle 9 requires: "The supervisor takes a risk-based approach to supervision that uses both off-site monitoring and on-site inspections to examine the business of each insurer, evaluate its condition, risk profile and conduct, the quality and effectiveness of its corporate governance and its compliance with relevant legislation and supervisory requirements. The supervisor obtains the necessary information to conduct effective supervision of insurers and evaluate the insurance market." While distinctions are sometimes drawn between risk-based and compliance-based approaches to supervision, confirming compliance with supervisory requirements is an essential part of supervision. Those requirements are generally formulated to prevent or mitigate risks. While an approach based purely on compliance can readily lead to a checklist mentality, compliance monitoring of some kind is essential to give assurance that intended outcomes are in fact being achieved, and may also help to identify more deeply-seated risks.

⁶ Where we use the term "regulation", we mean all the rules that regulated undertakings are required to adhere to, and which are supervised by the RSA, at whatever level they are set. The term therefore covers primary legislation, secondary legislation, rules made by the RSA, etc., whatever the term used to describe them in the jurisdiction in question.

22. Within a risk-based framework, an overall objective is to assess a TU/RTU's current and prospective solvency, its treatment of customers, and certain other risks such as those associated with financial crime. The RSA should therefore compare the risk profile of the TU/RTU with its ability to manage and to bear those risks, and seek to detect any issues that may adversely affect the undertaking's capacity to meet its obligations towards participants in the long term. The supervisor will also need to evaluate:

- the assets and liabilities (including off-balance sheet commitments);
- the technical operations (e.g. actuarial methods, underwriting policy, *retakāful*/reinsurance policy);
- the treatment of customers and whether any activities being engaged in are unfair, unlawful or improper, or are inconsistent with the claim to Sharī'ah compliance;
- the accounting and internal control systems;
- the undertaking's compliance with supervisory requirements;
- the undertaking's arrangements for business continuity, disaster recovery and succession planning;
- the undertaking's recovery and resolution planning;⁷
- the corporate culture and the effectiveness of the TO/RTO's corporate governance and risk management; and
- the undertaking's organisational structure and any implications of belonging to a group.

23. A framework such as this provides the RSA with a structured method for understanding and assessing key risks inherent in a TU/RTU's activities – for example, whether its risk management processes are adequate in the context of the key risks to which it is exposed, and whether its earnings, capital and liquidity are sufficient to enable it to support its risk profile and withstand unexpected shocks affecting or arising from the shareholders' fund (SHF), participants' risk fund (PRF) and participants' investment fund (PIF). It also allows the RSA to assess the likely effectiveness of the undertaking's internal controls in reducing the impact of risk events if they occur. The RSA can use this assessment to tailor the supervisor's own activities and interventions in individual firms. This, in turn, allows the RSA to allocate appropriate resources to the supervision of individual TUs/RTUs and to identifying and addressing market-wide issues.

24. RSAs typically develop a supervisory plan for each undertaking they supervise. This helps them to decide how much of the supervisory resources at their disposal should be

⁷ The IFSB has issued WP-07: *Recovery, Resolution and Insolvency Issues for Institutions Offering Islamic Financial Services*. Section 3.4.3, in particular, of the working paper discusses key recovery issues in *takāful*.

devoted to each undertaking, and to prioritise examination of the areas that represent the greatest threat to their objectives. The methodology adopted may vary from jurisdiction to jurisdiction, but takes into account both the potential impact of each risk and the assessed probability that the risk crystallises. So, an RSA concerned solely with prudential supervision will consider the impact that the failure of an undertaking would have on stakeholders (principally, participants) and on the market, and assigns a ranking or score. The RSA also considers the probability of failure, and again assigns a ranking or score. The combination of probability and impact informs the supervisory plan that the RSA prepares for each undertaking that it supervises. For example, an undertaking considered to have both a low probability of failure and a low potential impact of that failure might be subjected by the RSA only to a baseline level of monitoring, with infrequent on-site inspection. By contrast, an undertaking with both a high probability of failure and a high potential impact of that failure would attract close and continuous supervision. Where impact is high and probability low, or vice versa, the RSA decides its approach taking into account the nature of the risk. The RSA's analysis, and the supervisory plans that are developed as a result, should be subject to continual review in order to enable the RSA to reflect changes in the circumstances of firms and the environment in which they operate.

25. An RSA may have multiple objectives. It may, for example, need to consider not only the risk of the financial failure of an undertaking, but also other risks as well, such as the risk that the undertaking will sell unsuitable products to its customers, or that it will be used to launder the proceeds of crime. Weighing these disparate risks against each other is more difficult and inevitably involves a large element of judgment. RSAs nevertheless do this, either explicitly or implicitly. A supervisory plan might therefore conclude that a firm requires no more than baseline monitoring for financial matters but represents a threat to market standards of conduct warranting closer supervision of its business practices.

26. In the process of developing a supervisory plan, an RSA will typically analyse the risk initially recognised to identify the various elements that may contribute to it. For example, underwriting risk, *retakāful*/reinsurance risk and investment risk could all contribute to the financial failure of an undertaking but, based on considerations of impact and probability in the particular case, the RSA might choose to devote more resources to one of these than to the others. In this manner, the supervisory approach to individual TUs/RTUs may be further refined.

27. Where an RSA supervises TUs/RTUs, a methodology of this type requires consideration of the specificities of *takāful/retakāful*. In particular, the assessment of impact

and probability must take account of the segregation of funds, since different PRFs may carry different levels of risk depending on their business, in terms both of solvency and of conduct. The RSA also needs to consider the possibility that one PRF is affected by problems in another PRF or in the SHF, as well as how to address the risk of Sharī'ah non-compliance, which may have impacts from both the prudential perspective and that of conduct of business. As already noted, the degree of responsibility that RSAs will have for supervising Sharī'ah non-compliance varies from jurisdiction to jurisdiction, but this aspect of the operations of a TU/RTU is of relevance, at a minimum, to assessment of governance, even where an RSA has no specific responsibility in this area. Accordingly, RSAs should consider both the potential impact and the probability of Sharī'ah non-compliance at a level that is appropriate to their responsibility, and reflect their assessment when developing their planned supervisory activities for each TU/RTU.

28. Where an RSA is responsible for supervision of captive TUs/RTUs, the RSA should recognise that the regulatory risk inherent in such captives can vary substantially, depending on the type of captive, and therefore the level of supervision that is necessary will vary. A pure captive represents the lowest regulatory risk because there are no unrelated participants or potential third-party beneficiaries. Those representing the highest regulatory risk are captives underwriting risks for unrelated participants or underwriting compulsory third-party liability risks where the third party has direct recourse to the TU/RTU. Such captives may pose risks similar to those of commercial TUs/RTUs and, to that extent, RSAs should consider applying a similar supervisory review approach to such captives as they do to commercial TUs/RTUs. In both these cases, however, the captive represents a form of risk retention by the parent company or group, and the risk-sharing aspects of *takāful* will not apply or will do so only within a limited group of related participants. Also, because the only client is the parent company or group, conduct regulation will be very limited. Some captives, however, are set up effectively by an affinity group to provide coverage to its members – for example, members of a medical association. In such cases, the regulatory approach is likely to be similar to that for any other *takāful* undertaking.

2.2 Supervisory Tools

29. While details of the supervision framework, flow or mechanisms may differ between RSAs, some supervisory tools and activities are commonly used. In an effective framework, their use will be integrated, and information derived from one will be used to inform the use of others, enabling the supervisor to adapt its approach to a firm in response to its findings.

2.2.1 Supervisory Reporting

30. RSAs require access to reliable information to allow them to assess the state of each firm, as well as the market more generally. Public documents, such as annual financial statements prepared under company law, may not provide all of the information that RSAs require, and the importance of supervisory reporting is emphasised in the ICPs.⁸ There should therefore be a core of scheduled returns whose content is specified in regulation. These returns typically provide detailed information on the assets, liabilities and net financial position of firms, granular data on the performance of the business, segmented according to different types of product, and additional information on income and expenses, as well as on risk exposures and risk mitigation arrangements. Supervisory reporting may also include a report from an actuary. Depending on the scope of the RSA's authority, scheduled returns may also include matters such as complaints data. The information received facilitates off-site monitoring, allowing the RSA to assess the firm against market information and its own historical performance, and to apply regulatory benchmarks to identify potential indications of emerging problems.

31. RSAs with responsibility for supervising TUs/RTUs need to consider what information and statements they require from these entities on a regular basis. The segregation of funds that is typical of TUs/RTUs calls for reporting at the level of the fund as well as the TU/RTU as a whole. Where an RSA has responsibility for supervising Shari'ah matters, it could consider obtaining periodic statements from a TO/RTO's Shari'ah board, in addition to more typical statements or certificates from its management or actuaries.

32. To secure the desired information, RSAs should establish documented procedures and guidelines for reporting, with a comprehensive communication regime to ensure continuous information flow between the RSA and the TOs/RTOs. In addition to specified periodic reporting, TOs/RTOs should be required to submit timely information about their financial condition and performance, report on their outsourced functions, and report promptly any material changes to their information (e.g. the issue of additional capital, the occurrence of large claims, or the emergence of a deficit at fund level) that could affect their condition.

33. The appropriate level of a TO/RTO's senior management should have regulatory responsibility for the timing and accuracy of financial and statistical reporting as well as other reports required to be submitted or published. RSAs should also require prompt correction of

⁸ In particular, ICP 9; the IAIS has also published an "Application Paper on Information Gathering and Analysis" (2010).

inaccurate information provided or published by TOs/RTOs, and identify reports and information to be subject to independent audit and/or actuarial review. The RSAs should also require submission of annual audited financial statements.

2.2.2 Off-site Monitoring

34. Off-site monitoring or inspection by RSAs is the process of reviewing the information provided by the TOs/RTOs. Off-site monitoring is performed through collection and analysis of information provided by the TOs/RTOs (scheduled prudential returns and other returns, ad-hoc information requested by the RSAs, information sharing from other supervisors, and information obtained from other relevant sources). The information enables RSAs to identify trends in the industry and within individual TUs/RTUs, which may not be readily obtained through on-site visits. The content, format and frequency of the information required will depend on the nature, size and complexity of the TUs/RTUs.⁹

35. The supervisor should establish and follow written procedures for the analysis and monitoring of the supervisory reports that it receives. These may be conducted by individual supervisory staff using monitoring tools and/or specialised analysts/actuaries, as appropriate. The procedures should include those for assessing the valuation of assets, liabilities and technical provisions, such as reviewing and analysing actuarial reports and audit reports (whether internal or external) and other reports as necessary, both quantitative and qualitative. Off-site monitoring should include a risk-based analysis of various risks relevant to the TU/RTU, such as credit, market, underwriting, reserving, liquidity, operational, conduct of business, Sharī'ah non-compliance, legal, strategic and reputational risks. It may include comparison against industry benchmarks to identify possible areas of concern.

36. An RSA should also consider at least the following activities when planning and conducting off-site monitoring of TUs/RTUs:¹⁰

- Analysing, in a timely manner, information received from TOs/RTOs. Analysis by the RSA may provide a deeper understanding of developing trends affecting an TU/RTU and its participants, its risk tolerance and its strategy. Analysis by business lines may provide insights into the TU/RTU's risk profile and business model and practices.

⁹ It may also vary according to the scope of the RSA's responsibility; for example, an RSA with responsibility for supervision of anti-money laundering in the insurance sector might require reporting on this matter, both routine and incident-related.

¹⁰ The Annex to ICP 9 provides further examples of off-site monitoring activities.

- Obtaining and analysing, in addition to periodic supervisory reporting, materials relevant to the direction of the business such as business plans, papers for and minutes of meetings of the board of directors (BOD)¹¹ and significant committees, and *retakāful*/reinsurance programmes and contracts.
- Analysing the structures, operations and reporting of the key governance and control functions, including risk management, compliance, Sharī'ah compliance, internal audit and internal Sharī'ah audit.
- Considering the position of the TU/RTU in any group and the risks that it may pose to the RSA's supervisory objectives. Information could include group structure charts, information on material entities in the group, including non-regulated entities, and details of intragroup relationships such as shareholdings, service contracts and loans.¹² Where the RSA does not have direct supervisory power, or only limited power for the off-site monitoring of non-regulated entities, including holding companies, the RSA should at a minimum review the potential adverse impact on the TU/RTU of such non-regulated entities (see section 4.1).
- Analysing the major categories of the TU/RTU's business, the participants, the geographical spread of business, and the distribution model(s) used, in order to identify concentrations of risk exposure, areas of conduct risk, or vulnerability to potential market developments.
- Analysing the *takāful/retakāful* contracts offered by the TU/RTU, in order to understand the risk profile of the company and potential for risks arising from contract conditions, or commissions paid to intermediaries.
- Evaluating the TU/RTU's financial strength through analysis of claim settlement patterns and technical provisions, operations by line of business, investment policy, litigation and other contingencies, and off-balance sheet commitments.

37. While it is appropriate for an RSA to provide public information relating to its approach to supervision, the detailed procedures, benchmarks and early warning systems that it uses in its assessment may be kept confidential to the RSA, to allow for flexibility in particular cases or where conditions change, and to reduce the risk that TOs/RTOs seek to manage the information supplied in a manner that avoids triggers for supervisory action.

¹¹ Or equivalent governing body, for types of undertaking or jurisdictions that apply different governing structures.

¹² In order to be Sharī'ah-compliant, a loan must be free of interest.

38. Proper documentation of each off-site review should be maintained by the RSA, and used to record findings to be followed up by on-site inspection and other means such as requests for information or for the provision of an expert report on a particular matter.

2.2.3 On-site Inspection

39. On-site inspection is undertaken by the RSA at the location of the TUs/RTUs. It is an important part of the supervisory review process, and should be integrated with other activities, drawing on the findings of the off-site monitoring process and in turn influencing the focus of off-site supervision. It provides further information to supplement the analysis of the data submitted by the TOs/RTOs to the RSA. While some aspects of off-site monitoring are often performed in a systematic manner, on-site inspection is usually customised to the particular TUs/RTOs, taking into consideration the nature, scale and complexity of the TUs/RTUs, the results of off-site analysis, the risks that the RSA considers the TUs/RTUs to entail, and the findings of the inspection itself as it proceeds.

40. An on-site inspection requires careful planning on the part of the RSAs, in order to achieve appropriate allocation of resources for specific supervisory tasks. The inspection should begin with an overview of the TU/RTU in order to plan the fieldwork properly for that firm. The RSA needs to establish priorities for the areas to be inspected, define the nature and scope of inspection, and identify individuals with the right expertise to perform the inspection. Communication needs to be made with the TO/RTO regarding the planned inspection. However, RSAs should be aware of the risk that the TO/RTO will take selective action to improve the impression that the inspection will achieve, if excessive notice and/or details of the planned inspection are given.

41. A principal objective of the on-site inspection, apart from verifying the accuracy of information in financial and statistical reports provided during off-site monitoring, is to evaluate the TU/RTU's current and prospective solvency. The RSA should compare the risk profile of the TU/RTU with its risk-carrying capacity in order to detect any problem that may affect the TU/RTU's capacity to meet its obligations towards its stakeholders – primarily, participants – in the long term.

42. On-site inspection provides an opportunity for the RSA to have dialogue with the TO/RTO's management about taking action to avoid current or future problems, which may be more efficient than through regulations. This may also be an avenue for the RSA to provide the TO/RTO with information, especially concerning market-wide activities of the RSA, or

changes to regulations that are being contemplated, which might need to be explained in order to present the RSA's perspective.

43. It is usual for an RSA to undertake at least the following activities during regular on-site inspections, although some, if the RSA judges that they represent areas of lower risk, may not be undertaken on every inspection:

- assessment of the TU/RTU's financial strength, including the valuation of assets, technical provisions and other liabilities in each component fund of the TU/RTU, and the ability of capital resources in each fund to absorb losses;
- evaluation of the adequacy of any Own Risk and Solvency Assessment or similar exercise undertaken by the TO/RTO, and conclusions as to the risk profile of the undertaking;
- consideration of risk mitigation arrangements, including the *retakāful*/reinsurance cover and its security;
- assessment of the quality of corporate governance through evaluation of the BOD, senior management and the internal control system;
- assessment of the culture of the organisation, through observation and interview, and by examining internal communications and incentive arrangements;
- assessment of the effectiveness of the TO/RTO's arrangements for Sharī'ah governance, including its internal control systems and compliance monitoring in this area;
- analysis of the nature of the TO/RTO's activities – for example, the type of business written, the client base and the distribution channels, and drivers of surplus, deficit, profit or loss in the different component funds of the undertaking;
- evaluation of the technical conduct of *takāful/retakāful* business, including setting of contribution rates, handling of claims, handling of complaints, and attribution of cash flows between funds; and
- analysis of the relationships with external entities, such as through outsourcing or with respect to other companies in the same group.

44. Other aspects of a TO's or RTO's operations that may be covered on an on-site inspection, if they are within the responsibilities of the RSA, include the TO/RTO's procedures for anti-money laundering and prevention of terrorism finance, and its procedures for dealing with complaints.

45. In some jurisdictions, an RSA may delegate the performance of all or part of an on-site inspection activity to independent professionals. Where this is the case, the RSA should ensure that it retains effective oversight over the work performed, and that the professionals performing the inspection are suitably independent from the TO/RTO, are obliged contractually or by law to maintain confidentiality, and are required to make their records of the inspection available to the RSA.

46. Information gathered from the inspection exercise should be documented for ease of further analysis, as well as to support any conclusions that arise from the inspection. It is desirable for a summary of findings and/or observations of the supervisory review to be provided to the BOD of the TO/RTO.

2.2.4 Supervisory Follow-up¹³

47. Findings of the RSAs for both the off-site monitoring and on-site inspection may require further follow-up or monitoring by the RSA. Some tools that might be used for this purpose include targeted on-site inspections, reports by specialists on particular aspects of the TO/RTO's operations (e.g. its underwriting controls), or a change in the content or frequency of periodic returns.

48. Other findings may require corrective action by the TOs/RTOs. Weaknesses in risk management, and actual or potential deficiencies in compliance, need to be promptly highlighted and discussed with the TO/RTO. An appropriate response needs to be obtained from the TO/RTO, and there must be follow-up to ensure that required actions have been taken. During, or at the conclusion of, any on-site inspection, the supervisor should discuss findings with the TO/RTO and pay appropriate attention to the TO/RTO's comments in response. Where appropriate, findings may be amended on the basis of additional evidence, prior to finalisation. Whether the issues arise from on-site or off-site supervision, TOs/RTOs will need to provide a plan for addressing the concerns raised by the RSAs. Actions may be formally mandated using powers available to the RSA, but in many cases they will be agreed without invoking such powers.

¹³ The terms that supervisors apply to the various types of action available to them, including what they regard as "enforcement", vary considerably from jurisdiction to jurisdiction. This standard distinguishes between supervisory follow-up, aimed at obtaining further information or inducing a TO/RTO to undertake preventive or corrective actions, and enforcement, which involves the use of formal coercive powers and may also include the imposition of penalties on a TO/RTO or individuals for failure to maintain compliance.

49. Supervisory actions will normally be aimed at mitigating risks. Most commonly, the focus will be on reducing the probability that a risk will crystallise – for example, by strengthening the undertaking’s capital position or its Sharī’ah compliance function. However, in some instances the focus can be on reducing the impact of a failure – for example, by reducing the scale of the undertaking’s operations. Supervisory actions, where appropriate, should be communicated to the BOD of the TO/RTO.

50. Supervisory follow-up is a necessary process in ensuring that TOs/RTOs that have submitted satisfactory plans to deal with the issues raised by their RSAs have implemented these plans effectively. The frequency of follow-up depends on the severity of the concerns raised. It may range from having the follow-up in the next routine on-site inspection (for minor concerns), to having frequent follow-ups (for more serious concerns). Where the RSA has in place a formal system of trigger levels for capital adequacy purposes, along the lines recommended in IFSB-11, it is likely that the use of certain powers for prudential purposes will depend on a particular trigger level¹⁴ having been breached.

2.2.5 Enforcement¹⁵

51. Supervisory enforcement action is usually undertaken when a firm’s response to supervisory action is judged inadequate, or where breach is so severe that the supervisor considers that enforcement action is warranted. Enforcement action is also a part of a risk-based supervision system, aimed at reducing the likelihood or impact of failure; for example, a fine may reduce the probability that the undertaking will offend again, and may also have a deterrent effect on other firms.

52. In exercising its power to enforce corrective action in a timely manner, the RSA needs to be able to issue formal directions to TOs/RTOs to take particular actions or to cease from taking particular actions. A range of actions is available in order to apply appropriate enforcement where problems are encountered. The supervisor should at least have the power to issue the following:¹⁶

- a. Directions to reinforce financial position:
 - i. requiring measures that reduce or mitigate risks;
 - ii. requiring an increase in capital;
 - iii. restricting or suspending dividend or other payments to shareholders;

¹⁴ Most commonly, the Prescribed Capital Requirement.

¹⁵ See footnote 13 above.

¹⁶ In a similar manner to that required by paragraph 11.2 of ICP 11, “Enforcement”.

- iv. restricting purchase of the TO/RTO's own shares; and
- v. similar actions at the level of a PRF to reinforce the financial position of that PRF.

b. Restrictions on business activities:

- i. prohibiting the TU/RTU from issuing new *takāful* or *retakāful* policies;
- ii. withholding approval for new business activities or acquisitions;
- iii. withholding or withdrawing approval for outsourcing arrangements;
- iv. restricting the transfer of assets;
- v. restricting the ownership of subsidiaries; and
- vi. restricting activities of a subsidiary where, in the RSA's opinion, such activities jeopardise the financial situation of the TU/RTU.

c. Other directions:

- i. arranging for the transfer of obligations under the policies from a failing TU/RTU to another TU/RTU that accepts this transfer;
- ii. suspending or revoking the licence of a TO/RTO; and
- iii. barring individuals acting in responsible capacities from such roles in future.

53. After corrective action has been taken or remedial measures, directions or sanctions have been imposed, the RSA needs to check compliance by the TO/RTO and assess the effectiveness of the measures. Effective means should be available to address management and governance problems, including the the RSA having power to require the TO/RTO to replace or restrict the power of BOD members, senior management, persons in key control functions, significant owners and external auditors in addition to the ability of the RSA to replace or require the replacement of Sharī'ah board members with alternatives, based on justified decision and reasonable grounds and where the RSA considers that such persons have failed to undertake the responsibilities assigned to them or are unsuitable to hold the position. Any such action taken by the RSA should be subject to the requirements of due process, including appropriate rights of appeal.

54. In certain circumstances, sanctions by way of fines or other penalties may be imposed by the RSA on TOs/RTOs or on particular individuals where the provisions of the legislation have been breached. The RSA may also need to consider referring a case to other regulatory or law enforcement authorities. Sanctions imposed by the RSA should be proportionate to the identified breach.

2.2.6 Event-based Supervision

55. In addition to a planned programme of off-site and on-site supervision, an RSA will need to respond to certain types of events as they occur. In some cases, this will be because the RSA needs to be notified of, or give its consent to, certain changes. Common examples would be a change in the ownership of the TO/RTO or in the membership of the BOD. In other cases, it will be because the RSA becomes aware of a development that may impact the undertaking's position. An example might be a natural disaster that appears severe enough to have a material impact on the TU/RTU's financial position. In either event, the RSA will need to evaluate the new information in the light of what is already known about the undertaking and its risk profile, and to consider whether any necessary approval should be given, or any intervention, formal or informal, made. Whether or not action is taken, any change in the undertaking's risk profile (positive or negative) from the event should be recorded.

2.2.7 Thematic Review

56. Thematic review is not itself a part of the supervisory review process relating to an individual institution; it operates separately, at the level of the sector, rather than the individual institution. An RSA may undertake thematic review work in order to assess a current or emerging risk arising from an industry-related issue across a number of institutions within a sector or market. The purpose of a review of this nature is to allow the RSAs to further analyse key risks that come to its attention, during the supervisory review process or otherwise. If specific risks are identified, further inspection work will be carried out in the particular area of concern.

57. Thematic review is usually performed by a specialised team. This team typically works with industry practitioners and trading professional bodies to understand current practice, concerns and potential solutions.

58. Even where thematic work does not detect regulatory non-compliance, issues identified or analysed through this activity may lead the RSA to propose amendments to regulations, issue guidance or request changes to industry practices. The findings of thematic reviews provide input to the planning of off-site and on-site supervision of relevant firms.

SECTION 3: KEY ELEMENTS IN THE SUPERVISORY REVIEW PROCESS OF *TAKĀFUL/RETAKĀFUL* UNDERTAKINGS

3.1 Corporate Governance

59. IFSB-8: *Guiding Principles on Governance for Takāful (Islamic Insurance) Undertakings* provides guiding principles on corporate governance with three main objectives: (a) reinforcing relevant good governance practices, based on those prescribed by other internationally recognised governance standards; (b) striking a balance between the interests and fair treatment of all stakeholders; and (c) providing a solid foundation for all the IFSB's future standards that relate to good governance of *takāful* undertakings.

60. There is no “single model” of corporate governance that fits all *takāful/retakāful* models. The RSAs need to review the controls and the quality of internal governance that have been put in place to ensure that they are commensurate with the size, complexity and nature of the business, as well as with the general framework of the TOs/RTOs. The general elements of governance for TOs as set out in IFSB-8 include:

- a. managing a comprehensive governance framework appropriate for their *takāful/retakāful* business models;
- b. adopting an appropriate code of ethics and conduct to be complied with by their officials at all levels;
- c. having in place an appropriate governance structure that represents the rights and interests of *takāful/retakāful* participants;
- d. adopting and implementing procedures for appropriate disclosures that provide *takāful* participants with fair access to material and relevant information;
- e. ensuring that the TOs have in place appropriate mechanisms properly to sustain the solvency of TUs; and
- f. adopting and implementing a sound investment strategy and prudently managing the assets and liabilities of TUs.

61. IFSB-8 was not intended to cover *retakāful*, where the issues are a little different because the cedants, being themselves TUs, have a higher level of knowledge and negotiating power than most private individuals. The corresponding principles for RTOs are discussed in

IFSB-18. In addition, some elements of IFSB-8 have subsequently been further developed in later standards, notably IFSB-11 and IFSB-14.

62. In performing a comprehensive evaluation of a TO/RTO's overall governance policies and practices, the RSA needs first to ensure that it comprehends the TO/RTO's ownership structure based on the general framework of the operating model, which should have the effect of ensuring a clear segregation of funds as required by relevant Sharī'ah rules and principles.¹⁷ This segregation will facilitate the subsequent understanding of the sources of capital through which the rights and obligations of various stakeholders will be ascertained.

63. The RSA should further satisfy itself that the TO/RTO has robust corporate governance policies and processes that are commensurate with its risk profile and systemic importance. This may be done through the review of internal policies, procedures, systems and controls in order to assess the adequacy of these in light of the TO/RTO's risk profile.

64. An RSA should require the TO/RTO to demonstrate that BOD members, senior management and those in key control functions are suitable to hold those positions, when they are first appointed and on an ongoing basis thereafter. The RSA may also prescribe more general "fit and proper" criteria which the TO/RTO should use in considering the suitability of staff outside the group of persons requiring notification to the RSA, and should evaluate whether the firm is using these criteria effectively.

65. The RSA should satisfy itself that these positions are held by people who possess appropriate integrity, skills and experience for the responsibilities. Where responsibility is shared, as is the case for the BOD or for a committee, the RSA should consider whether those concerned possess the appropriate skills and experience to the necessary extent as a body. In evaluating the continuing suitability of BOD members, and those in key control functions in particular, the RSA should consider matters such as participation in board meetings, independence of opinion, effectiveness of oversight of the key control functions, and whether there is a record of challenging and holding to account the senior management.

66. The RSA should ensure that the BOD establishes a clear allocation of responsibilities to various members of management and organs of governance (such as Audit Committee, Internal Audit and Internal Sharī'ah Audit). When evaluating the independence of the board members and their suitability in overseeing the TO/RTO's fiduciary responsibilities and duties

¹⁷ This segregation may not be mandatory in the case of undertakings operating other than on the hybrid model.

concerning the rights and obligations towards the various stakeholders, tools available to the RSA include: (a) interviewing members of the BOD; and (b) reviewing and analysing the minutes of meetings of the BOD and its committees, the remuneration structures adopted by the BOD, auditors' and actuaries' reports, and, if any, IT audits. Analysis of a full board pack may help to indicate how seriously the BOD is involved in considering the risks, including Sharī'ah non-compliance risk, to which the undertaking is exposed. The RSAs need to be satisfied that the BOD is ultimately responsible for the overall effectiveness of the TO/RTO, including the processes and effectiveness of its Sharī'ah board and the implementation of its *fatwas*/Sharī'ah resolutions.

67. A particular issue in TUs/RTUs is proper consideration of the interests of participants, which may at some points diverge from those of shareholders. For example, whenever an investment opportunity arises, a decision needs to be made as to whether it is taken up using shareholders' funds or participants' funds. Again, a TO may be tempted to maximise the income generated from contributions in order to benefit from *wakalah* fees, even if the business may be unprofitable for the PRF. These issues are discussed at greater length in IFSB-8, which recommended a Governance Committee to find an appropriate balance between the interests of all stakeholders. It did, however, note that alternative institutional arrangements might be possible. Where the governance arrangements assign specific responsibility for representing participants' interests to a body or individual, the RSA should evaluate whether this responsibility is being discharged effectively – for example, by considering the resources and authority available to that body or individual, any other responsibilities they have, their incentives for proper performance, and the substantive decisions made.

68. In reviewing the suitability and roles of senior management and control functions, the RSAs should ascertain that the respective responsibilities are clearly articulated and that this articulation is followed in practice. The RSAs should ascertain the effectiveness of the senior management and the control functions, their ability to challenge the TO/RTO's policies and procedures, and the willingness of management to acknowledge improvement needs and to correct mistakes in providing effective oversight for the business. The review should also ensure that the operations overseen by the senior management and control functions are in compliance with sound and prudent principles, as well as with those of the Sharī'ah, and that there are clear and well-defined reporting lines of responsibility. For functions that are outsourced, the RSA should satisfy itself that the TO/RTO retains responsibility for these functions and that the RSA's ability to conduct its supervisory activities is not impeded by the arrangements.

3.2 Sharī'ah Governance

69. IFSB-10: *Guiding Principles on Sharī'ah Governance Systems for Institutions Offering Islamic Financial Services* outlines the basic principles behind a Sharī'ah governance framework, with full recognition that the responsibilities of TOs/RTOs' Sharī'ah boards may vary between TOs/RTOs and jurisdictions. Given the different Sharī'ah governance structures and models that have been adopted in various jurisdictions, there is no "single model" or "one-size-fits-all" approach.

70. The basic Sharī'ah governance system as recommended in IFSB-10 should contain relevant ex-ante and ex-post processes. The former concerns the issuance of Sharī'ah pronouncements/resolutions and compliance checks before the product is offered to the customers (ex-ante compliance), whereas the latter is about internal Sharī'ah review and Sharī'ah governance reporting (ex-post compliance).

71. In evaluating the effectiveness of the Sharī'ah governance framework of a TO/RTO, even in jurisdictions where the RSAs do not take or implement positions on substantive Sharī'ah issues, RSAs should verify that the Sharī'ah board is adequately knowledgeable with respect to the business and is independent, giving consideration to the suitability, background and qualification of its members. The concept of independence is discussed at greater length in IFSB-10.¹⁸ It implies not having unduly close ties to owners or senior management, not having personal interests that may diverge from those of the undertaking, maintaining confidentiality of information from different clients, and avoiding or addressing any conflicts of interest between a member's responsibilities to different clients. The RSAs should evaluate the independence of these Sharī'ah board members through considering their experience, reporting lines, other duties and remuneration arrangements, and by examining and analysing the minutes of meetings of the Sharī'ah board, and reviewing internal and/or external Sharī'ah audit reports.

72. Whether similar formal "fit and proper" requirements as are applied to directors are extended to members of the Sharī'ah board will depend on the approach taken by the RSA to Sharī'ah governance. However, suitability is a continuous requirement, and it is appropriate for an RSA to evaluate whether persons are suitable for appointment and, once appointed, remain suitable, taking into account the balance of skills within the undertaking.

¹⁸ See, in particular, paragraphs 40–45 and Appendix 3.

73. RSAs should verify that the TO/RTO has put in place internal policies, processes, systems and controls in the areas of Sharī'ah compliance and audit whereby the Sharī'ah board is provided with complete, adequate and timely information on any product or transaction on which a pronouncement is sought, including having its attention drawn to any areas of possible difficulty identified by the TO/RTO's management. It may be appropriate to confirm this by analysing the papers submitted to a meeting of the Sharī'ah board and its minutes, and/or by interviewing Shari'ah board members, when necessary. The RSA should check that the internal Sharī'ah compliance review/audit has been carried out appropriately and its findings have been presented to and duly considered by the Sharī'ah board.

74. Where the Sharī'ah board has made a pronouncement that is valid for a limited period or under specified circumstances,¹⁹ the RSA should check that appropriate procedures exist for review at the end of the period, or for periodic confirmation of whether the specified circumstances continue to apply.

75. The RSA should also verify that the Sharī'ah governance framework contains procedures for issuance of relevant Sharī'ah pronouncements/resolutions and dissemination of such pronouncements/resolutions to those personnel within the TO/RTO who are responsible for monitoring day-to-day compliance with Sharī'ah pronouncements/resolutions. Where a Sharī'ah board at the level of the jurisdiction or the RSA makes pronouncements that are binding on individual firms, the RSA should confirm that mechanisms exist for bringing these to the attention of the firm's Sharī'ah board and relevant staff.

76. The RSA should obtain a sufficient understanding of the policies and procedures for consultation between directors and senior management and the Sharī'ah board to assess whether these provide adequately for proper consultation with the Sharī'ah board on all relevant matters and due consideration of the results of such consultation. Relevant matters for this purpose are those where significant inherent risk of Sharī'ah non-compliance is identified or may exist. The RSA should also assess the approach of the board and senior management to reports and consultation from the Sharī'ah board.

¹⁹ An example might be permission to use conventional reinsurance rather than *retakāful*, based on arguments of *dharurah*.

3.3 *Takāful* Operational Framework

77. Given the differing approaches of regulatory frameworks and RSAs in different jurisdictions, this standard does not provide detailed guidance to the RSAs on the mechanism for review of *takāful* models operated by TOs/RTOs. It is, however, envisaged that RSAs should, during their review of the TOs/RTOs, ensure the existence of some basic elements required in a *takāful* or *retakāful* operation.

78. Where the operating model is not prescribed by regulation or by a centralised Sharī'ah authority, the RSA should ensure that the model has been subjected to proper Sharī'ah consideration and approval. If any aspects of the model appear questionable to the RSA on Sharī'ah grounds, the RSA may wish to look in more detail at how these aspects were presented to the Sharī'ah board.

79. Whether or not any aspects of the model are prescribed, the RSA should have a clear understanding of how the model is intended to operate. It should be alert to any divergences between the model as designed or prescribed and actual practice within the TU/RTU. If actual practice is different from that prescribed by regulation, the RSA should take appropriate action. Even if it is not different, the RSA should ensure that any changes have been given proper Shari'ah consideration and also understand whether they have changed the risk profile of the TU/RTU – for example, by changing incentives to behave in particular ways.

80. The RSA needs to satisfy itself that its review of a TO/RTO's *takāful* model is backed by a clear understanding of what the model implies, particularly in terms of segregation of funds and assignment of receipts and payments to those funds. Where the *takāful* model requires a segregation of the assets and liabilities of the SHF, PRF and PIF, the RSA's review of the *takāful* or *retakāful* operation should include examination of how this segregation is maintained. The RSA's procedures in this regard could include examination of financial statements and detailed accounting records. However, rather than being analysed directly by the RSA itself, these matters may be considered as part of the firm's internal or external audit, with the RSA looking at the results of these audits.

81. The *takāful* model will be implemented in part through the contracts between the TU/RTU and its participants. It may be appropriate to review a typical contract to ensure that it is consistent with the model. Particular attention should be given to any clauses allowing the TO/RTO to vary aspects of the model, or to vary charges (e.g. *wakalah* fees) made under it.

If there are such clauses, the RSA should check that they have been fully presented to the Sharī'ah board and have received its approval.²⁰

82. The RSA should assess the adequacy of the TO/RTO's compliance for the investment activities of the various funds of the TU/RTU. There should be clearly defined reporting lines and accountability of organs of governance, where stakeholders' interests and obligations are clarified and understood. A TO/RTO's processes should ensure that it is clear in advance of making any investment to which fund it is to be assigned, and that it is approved by the TO/RTO as appropriate to that fund within the approved risk framework, including any asset-liability matching requirements, and with appropriate Sharī'ah governance.

83. Some RSAs issue specific guidelines on the maximum allowable fee structure or the fee calculation mechanism for the various *takāful* models of the TOs/RTOs that are allowed to operate in their jurisdictions. They will need to ensure that any such guidelines are adhered to. Whether or not this is done, fee structures and/or calculation mechanisms should be clearly specified in the contracts with participants and have been approved by the Sharī'ah board. This will include any sharing of profits (e.g. from investments made under a *muḍarabah* agreement) and any performance-related incentive. RSAs may check that these contractual structures are being adhered to.²¹

84. RSAs should also gain an understanding of the policy of TOs/RTOs regarding the attribution of all cash flows under the contracts entered into, including justification of that policy by reference to the rights of participants and shareholders, and Sharī'ah compliance. At a minimum, the policy should cover the attribution of inflow/outflows in the form of contributions, *retakāful* payments, fees and other remuneration, and inflows/outflows in the form of commissions, brokerage, recoveries and distribution of surplus. Certain administrative expenses – for example, claims-handling costs, business acquisition costs and brokerage fees – may offer particular scope for manipulation, and the attribution of these should be clearly stated in the policy. This policy should be documented, approved by the BOD after Sharī'ah board review and approval, and be subject to periodic review. RSAs should require TOs/RTOs to have in place systems and controls to ensure implementation of the documented policy. The supervisory review will subsequently assess the implementation by the TOs/RTOs of these documented policies. Techniques for assessing whether the policy has been applied

²⁰ In some jurisdictions, any such clause might also be questionable under general consumer protection legislation.

²¹ Again, the audit process may offer scope to do this.

could include review of the outcome of periodic audits, the commissioning or requiring of independent reviews of the application of the policy, and direct inspection by the RSA.

3.4 Capital Adequacy

3.4.1 Available Capital

85. IFSB-11: *Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings* provides a basic framework for the solvency structure of a TO/RTO and the funds that it operates. A primary concern of the RSA will be the ability of TUs/RTUs to meet regulatory solvency requirements in a manner compliant with Sharī'ah rules and principles. In a hybrid *takāful* structure, this includes a separation between the functions of mutual protection against specified risks by means of risk pooling in *takāful/retakāful* funds and the management of the underwriting process and fund investments by the TO/RTO. IFSB-11 is built upon the following premises and objectives:

- a. to increase the likelihood that a *takāful* undertaking would be able to meet all its contractual obligations and commitments;
- b. to act as an early warning system for regulatory intervention and immediate corrective action, taking into account that the supervisory authority may sometimes have access only to incomplete information, and that even corrective actions may take time to generate the desired impact;
- c. to provide a buffer so that even if the *takāful* participants are to suffer a loss in the event of failure of a *takāful* undertaking, the impact can be limited or reduced, especially the systemic effects; and
- d. to foster confidence among the general public – in particular, *takāful* participants – in the financial stability of the *takāful* sector.

The seven Key Principles outlined in IFSB-11 complement the relevant solvency standards and guidelines developed by international standard-setting bodies.²²

86. Capital adequacy standards are premised on the need for capital resources (an excess of assets over liabilities, including technical provisions) to absorb losses. As set out in IFSB-11, due to the segregation of funds that is implicit in the hybrid *takāful* model, assets, liabilities

²² At the time of preparation of this standard, there is no detailed global insurance solvency standard analogous to the Basel regime. The IAIS is, however, developing such a standard for internationally active insurance groups.

and risks all need to be considered at the level of each fund, while taking account of the relationships between funds (e.g. any commitment to provide *qard*²³).

87. It follows that the management of risks that may result in loss is critical to the amount of capital required. RSAs should satisfy themselves that the TOs/RTOs have in place a comprehensive risk management framework, including a reporting process, incorporating appropriate board and senior management oversight, to allow the TO/RTO to identify, measure, monitor, report and control relevant categories of risks and, where appropriate, to hold adequate capital against material risks. Where capital is not an effective mitigant for particular risks, the risk management framework should provide for appropriate alternative mechanisms for mitigation, or for avoidance of the risk in question.

88. In the supervisory review process, the RSA should assess the processes of the TO/RTO for determining appropriate technical provisions separately for each PRF. TOs/RTOs should maintain a properly documented basis for setting technical provisions for each class or type of business. If the regulatory regime permits diversification benefits between different classes of business, the basis for setting these should also be documented. There should be proper actuarial review of these provisions, and the RSA will in appropriate cases use its own actuarial advisers to review them. The RSA will conduct peer group analysis of data and assumptions, and seek to understand outliers.

89. The value that is assigned to technical provisions for solvency determination purposes may differ from that used for public financial reporting. Historically, the requirements for measurement of technical provisions for public financial reporting of insurance/*takāful* business have often diverged significantly from those applicable to the determination of solvency, and an RSA may need to be alert for the risk that differences between financial statement values and regulatory measurements create incentives for management decisions that are not otherwise commercially justifiable, exposing the TU/RTU to unnecessary risk. The scope for such arbitrage is expected to reduce following the issue of an International Financial Reporting Standard (IFRS)²⁴ dealing with measurement of technical provisions on an economic basis.

90. Because the setting of technical provisions, especially in general *takāful*, is critically dependent on claims data (both claims received and claims settled), the RSA will wish to satisfy itself that claims are properly managed – in particular, that they are recorded as soon

²³ An interest-free loan from the shareholders' fund to the participants' fund.

²⁴ IFRS-17 on insurance contracts.

as they are received – and that claims data are appropriately recorded. Where provisions are set separately for individual claims, these need to be realistic and promptly documented. Particular problems may occur if claims handling, or initial claims recording, is outsourced; in such cases, the RSA may examine carefully the TO/RTO's own supervision of the service provider, and should be able if necessary to have direct access to the service provider itself. The setting of technical provisions can be a particular issue in *retakāful*, partly because of the inevitable lag between claims notifications to the TO and their notification to the RTO, and partly because of the greater volatility of much *retakāful* business. Particular scrutiny is therefore likely to be necessary in the case of an RTO.

91. Where the regulatory framework for determination of technical provisions requires deferral of unearned contributions or of acquisition expenses, the RSA should assess the processes of the TO/RTO for estimating the future claims and expenses attributable to contracts that are in force at valuation date, and for establishing additional technical provisions²⁵ or writing off deferred expenses, where necessary. The RSA should consider the assumptions used by the TO/RTO.

92. RSAs will need to ensure that the assets backing the technical provisions or otherwise supporting solvency are correctly valued. They should establish a hierarchy of acceptable methods of valuation and require the use, where possible, of the most reliable methods (taking into account any impairment in value). Valuation may be a particular issue in TUs/RTUs, because Sharī'ah-compliant assets such as *sukuk* are often not traded in deep and liquid markets. Where alternative valuation methods are used, RSAs should obtain an understanding of those methods and the governance applied by TOs/RTOs to their use, in order to assess the risk that the value assigned is greater than the amount for which assets could be realised for the benefit of participants. In addition, RSAs should take account of the suitability of assets for the purposes of backing the undertaking's liabilities and absorbing the risks to which it is exposed. There should be a consistent measurement of assets and liabilities, with identification and measurement of risks and their potential impact on all components of the balance sheet. RSAs should be alert to asset–liability mismatches, by duration, currency or location.

93. The RSAs' review of available capital should take into consideration any loss mitigation method used by the TOs/RTOs, be it through *retakāful*/reinsurance, *retrotakāful* /retrocession, or any other methods available within the risk mitigation system. RSAs need to satisfy

²⁵ Commonly referred to as an unexpired risk provision, though other terminology is also used.

themselves that the loss mitigation method is genuinely used to reduce the risk retained in the PRF in order for the TOs/RTOs to be able to manage their own capital requirements and to increase their capacity to accept new business. Careful consideration needs to be given by the RSAs when there is financial or finite *retakāful*/reinsurance (FinRe) since such arrangements may enable a misleading presentation of the financial strength of a party to the contract. In addition, the absence of pooling and the misalignment of form and substance generally render such arrangements non-Sharī'ah-compliant. Note that an apparently legitimate and appropriate *retakāful*/reinsurance may in fact be turned into a FinRe arrangement by side letters or by other associated agreements. If there is cause for concern in any particular case, the RSA may consider asking the TO/RTO formally to confirm that there are no other associated agreements. The supervision of TOs/RTOs' *retakāful*/*retrotakāful* programmes is discussed in more detail in Section C.V of IFSB-18.²⁶

3.4.2 Eligibility of Capital

94. IFSB-11 highlights the need for RSAs to ensure that the PRF has adequate resources to meet the claims from participants, and that the SHF has sufficient resources to meet its own financial and legal obligations.

95. Some solvency regimes use a formal tiering of capital akin to that of the Basel regime for banks. Where such an approach is used, loss absorbency criteria are likely to be set for each tier of capital. Some forms of capital may be subject to pre-approval by the RSA, even if they meet the prescribed criteria. The RSA will generally have to approve the issue of any capital instruments other than ordinary shares which are intended to be admissible for regulatory purposes. Where requested to approve the issue or use of an instrument as capital, the RSA will need to satisfy itself that the instrument has the necessary loss absorbency features, taking into account the Sharī'ah understanding of the contracts used and ensuring that they have been presented to the appropriate Sharī'ah board and have received its approval.

96. When a solvency test is applied at the level of the PRF, the RSA will likewise need to be conscious of what assets are admissible against the liabilities. In particular, they will need to consider the status of any *qard* advanced to the PRF, or any assets outside the PRF earmarked for any *qard* facility, and how they will operate in both a going concern and a gone concern situation (see paragraph 100).

²⁶ The Sharī'ah Board of the Islamic Development Bank does not consider financial, or finite risk, *retakāful* arrangements as Sharī'ah-compliant.

97. RSAs need to ascertain that the assessment of the solvency at the PRF level has properly taken into consideration any limitations on the transferability of funds within the undertaking. Such limitations may arise from the contractual terms or the legal framework that governs the undertaking's operations. This may occur, in particular, if multiple PRFs are established for different lines of business or, in family *takāful*, when the PRF is separated from a PIF.

98. In assessing the financial strength of the various funds of TUs/RTUs, RSAs need to verify the existence of any financial assistance mechanism that may be used to assist those PRFs which do not meet the minimum regulatory solvency requirements. *Qarḍ* is frequently identified as a means of providing additional capital to enable a PRF to meet its solvency requirements. RSAs should ensure, when reviewing this form of financial assistance provided by the SHF to a PRF, that they understand clearly the features and treatment of the *qarḍ*.

99. Where, under the regulatory framework, capital resources in the SHF are admissible as resources of the PRF (on the understanding that earmarked funds will be paid into the PRF as *qarḍ* if required), RSAs need to confirm that adequate, unencumbered capital exists in the SHF for this *qarḍ* facility to be effective, taking account of other potential calls on those resources. The RSAs require the TOs/RTOs to hold adequate capital in a suitable form, in addition to any stand-alone solvency requirements of the SHF, representing any amount designated by the TOs/RTOs as available to cover a solvency deficiency in a PRF or PRFs.²⁷

100. Paragraph 96 above refers to the loss absorbency of *qarḍ*, or assets earmarked for possible *qarḍ*. In particular, the RSA will need to understand how *qarḍ* will be treated should the TU/RTU reach the point where it may no longer be able to meet claims as they fall due. In such a situation, it would be expected that the entity would be placed into some kind of resolution procedure, whether under the oversight of the RSA or of insolvency practitioners appointed by a court. In such a situation, it needs to be clear where the SHF's claim to repayment of *qarḍ* ranks in relation to participants' claims on the PRF, and also whether any funds earmarked for *qarḍ* can be used to meet other liabilities of the SHF (e.g. staff salaries). The answers to these questions will affect how *qarḍ* should be treated in the assessment of solvency, and there should be clear documentation of the position.

²⁷ The requirements for capital to be acceptable for this purpose are discussed in IFSB-11, paragraphs 34–36.

101. RSAs should consider also the risk that the ability of capital resources to absorb losses may be undermined by related transactions, encumbrances, intragroup or intracompany obligations. In the context of a TU/RTU, RSAs should consider this risk at the fund level as well as the overall entity level, and make adjustments to eligible capital when they ascertain that capital is being recognised in more than one entity or in more than one fund within an entity, or where assets include amounts due from related undertakings that may not be readily realisable for the benefit of *takāful/retakāful* participants.

3.4.3 Determination of Capital Requirements

102. In respect of capital requirements for TOs/RTOs, this standard focuses on the supervisory review of a standardised approach for solvency calculation. Although some jurisdictions permit the use of internal models, subject to regulatory approval, this does not appear to be a significant feature of the *takāful/retakāful* sector at the time of preparation of this standard, and is therefore not considered further.

103. This standard articulates principles for the supervisory review process in the context of capital requirements as described in IFSB-11, comprising two specific solvency control levels. These are: (a) a risk-based Prescribed Capital Requirement (PCR), being a trigger for supervisory intervention due to deteriorating financial strength; and (b) a Minimum Capital Requirement, being a trigger for withdrawal of authorisation due to inadequacy of capital. The statements in this standard should be modified as appropriate for application in frameworks that follow a different approach.

104. The RSA should monitor the level of the PCR for a TU/RTU and its PRFs, and consider the range of solvency coverage that should be considered normal for the undertaking. The RSA should look at trends in the level of PCR coverage, both over time and relative to peer undertakings. The RSA should engage with senior management in the event of concern that the PCR may become breached in the future, and should also be alert to the possibility that a declining capital position may tempt the TO/RTO to be less prudent – for example, in the setting of technical provisions.

105. In determining the level of solvency monitoring to which a TU/RTU is to be subject, an RSA should consider both the likelihood and impact of failure of the TU/RTU, and subject the TUs/RTUs to closer and more frequent monitoring where the RSA considers that either the likelihood or impact of failure, or both, is high either absolutely or relative to other firms that the RSA supervises.

106. In general, a capital adequacy regime will give credit for loss mitigation techniques – in particular, *retakāful*/reinsurance.²⁸ The way in which this is done may vary. However, loss mitigation through *retakāful*/reinsurance is subject to two principal types of risk. One is that the relevant contracts are less effective in mitigating risks than is expected – for example, because of the way the *retakāful*/reinsurance programme is structured. The other is counterparty risk – in particular, the risk that the *retakāful*/reinsurance counterparty will fail. The use of *retakāful*/reinsurance arrangements should be verified to ascertain that the programme has been effectively structured to mitigate risk, and that the security of the *retakāful*/reinsurance counterparty has been appropriately considered. Whether or not this is formally required by the capital adequacy regime, TOs/RTOs should be encouraged not to be too dependent on any single counterparty or grouping of counterparties subject to similar risks.

107. A standardised formula by its nature cannot reflect the risk profile of all undertakings to which it is applied. The RSA should consider whether the risk profile of the TU/RTU (and of each of its funds where relevant) is reasonably consistent with the assumptions underlying the standardised formula. In this process the RSA will consider information from the Own Risk and Solvency Assessment (ORSA) performed by the TO/RTO. Further guidance on supervisory review of ORSA, and actions that the RSA may take where it forms the view that the risk profile of the TU/RTU or of one or more of its funds departs significantly from the underlying assumptions reflected in the standardised formula, is provided at section 3.4.4 below. The RSA should keep the assumptions underlying the standardised formula under review, and consider whether it is necessary to propose amendments to that formula.

108. When considering the capital adequacy of a TU/RTU, the RSA should consider the resolvability of the TU/RTU, in the event of a shock that renders its business model non-viable. The RSA should consider the potential impact on the undertaking, and in particular of its PRFs, should it become necessary to close a PRF or the undertaking as a whole to new business. Where the RSA considers that TU/RTU or a PRF would be incapable of solvent run-off, notwithstanding current solvency compliance, the RSA should consider the actions available to it to ensure mitigation of the risks to its objectives.

²⁸ Where conventional reinsurance rather than *retakāful* is used, this should be subjected to appropriate Sharī'ah governance, as discussed in IFSB-18 (paragraph 122 onwards).

3.4.4 *Own Risk and Solvency Assessment (ORSA)*

109. IFSB-11 identifies the need for ORSA and capital management processes to monitor and manage the level of an undertaking's financial resources relative to its economic capital and the regulatory capital requirements set by the solvency regime, while IFSB-14 recommends an ORSA whether or not the regulator specifically requires it. The performance and documentation of ORSAs provides valuable information to RSAs on risks to which individual firms are exposed and the significance of each firm in relation to the objectives of the RSA.

110. Where an ORSA is required, the RSA should obtain a report on each ORSA performed by a TO/RTO, and gain an understanding of the process undertaken and the results, based on review of this report supplemented, if necessary, by enquiry of the TO/RTO.

111. The primary purpose of the ORSA is to assess whether the undertaking's risk management and solvency position is currently adequate and is likely to remain so in the future. Responsibility for the ORSA therefore rests at the top level of the TO/RTO's organisation. The RSA should confirm that the TO/RTO's BOD and senior management have taken responsibility for performing it, agreeing the validity of the outcome and acting upon its findings. The RSA should also consider whether the performance of the ORSA, and decisions based on its results, received appropriate input as necessary from the TO/RTO's Sharī'ah board.

112. The RSA should consider whether the ORSA has been performed with appropriate governance, including validation of data, assumptions and parameters used, and strong critical assessment by members of senior management. It should look for evidence that data pertaining to the TUs/RTUs' exposure to risks, mitigation measures and sensitivity, and conclusions on the effective operation of the risk management framework, have been derived from systems and processes that have been tested for effective operation. The RSA should confirm that parameters and assumptions used in the projection of the financial position of the TUs/RTUs have been established on a realistic basis, consistent with that used by the TOs/RTOs for planning the business over the time horizon involved.

113. The ORSA should encompass all reasonably foreseeable and relevant material risks, including, as a minimum, underwriting, credit, market, operational and liquidity risks, Sharī'ah non-compliance risks, and additional risks arising due to membership of a group. The assessment is required to identify the relationship between risk management and the level

and quality of financial resources needed and available, on a forward-looking basis, taking into consideration the impact of future changes in economic conditions or other external factors. The RSA should use its own knowledge of economic conditions, and experience from review of ORSA reports from other comparable TUs/RTUs, to consider whether the ORSA properly covers these matters and to challenge the adequacy of the ORSA with senior management, where the RSA concludes that it is necessary.

114. Significant changes in the risk profile should prompt the TO/RTO to undertake a new ORSA. The RSA should consider whether information obtained by it indicates that a new ORSA should be performed. Risk assessment should be performed in conjunction with consideration of the effectiveness of applicable controls to mitigate the risks. In reviewing the ORSA report, the RSA should aim to confirm that the assessment of effectiveness has been performed for all key controls relied upon for mitigation of material risks that may have an impact on the TU/RTU's ability to meet its obligations to participants and to pay other debts as they fall due.

115. As part of its ORSA, the TO/RTO should determine the overall financial resources it needs in order to manage its business given its own risk tolerance and business plans, and to demonstrate that supervisory requirements are met. It will need to make assessments at the level of each fund – in particular, PRF and SHF – as well as for the TU/RTU as a whole. The RSA should expect the TO/RTO to base its own risk management actions on consideration of its economic capital, regulatory capital requirements and financial resources, including its ORSA, and to assess the quality and adequacy of its capital resources to meet regulatory capital requirements and any additional capital needs. As part of this process, the TO/RTO should analyse its ability to continue in business, and the risk management and financial resources required to do so over a longer time horizon (three to five years) than typically used to determine regulatory capital requirements. This is likely to involve consideration of the TO/RTO's medium- and longer-term business strategy, including how it could respond to unexpected changes in markets and economic conditions, innovations in the industry, and other factors such as demographic, legal and regulatory, medical and social developments. The RSA should assess whether the ORSA report indicates that the TO/RTO has given due consideration to these matters, and raise further enquiry with senior management where the RSA considers it necessary.

116. The RSA should consider whether the TO/RTO has given adequate attention in its ORSA to the segregation of the PRF, PIF (if any) and SHF, to identify risks affecting each fund and its impact on the stakeholders of the respective funds. The RSA should also look into the

potential impact of transactions between funds – in particular, *qard* (if applicable) or any other kind of financial assistance that the SHF will provide to the PRF.

117. Stress and scenario testing should be a normal part of the ORSA. That is, the TO/RTO should consider how it would be affected by business and economic stresses of various kinds, and also by specific loss scenarios (e.g. a major natural disaster affecting an area where it has significant business). It should also apply reverse stress testing to identify scenarios that would be the likely cause of business failure (e.g. where the business would become unviable or the market would lose confidence in it) and the actions necessary to manage this risk. The RSA should consider whether the stresses and scenarios used by the TO/RTO are consistent with the RSA's knowledge of the risk profile of the TU/RTU, and whether other stresses and scenarios are relevant and should have been considered. The RSA should consider whether the stress testing used covers all significant risk drivers, so that the overall impact of a given stress is quantified.

118. Depending on the outcome of the ORSA, and the RSA's review of it, the RSA may require strengthening of the TO/RTO's risk management, solvency assessment and capital management processes, notwithstanding that the firm complies with standardised solvency capital requirements. It may also, if its powers permit, set an individual capital requirement for the business, covering the PRF, SHF or both.

3.5 *Retakāful*

119. IFSB-18: *Guiding Principles for Retakāful (Islamic Reinsurance)* sets forth a set of five basic principles and associated best practices pertaining to *retakāful* activities of TUs/RTUs. Principles one to four address matters relevant to inward *retakāful* operations of TUs/RTUs, while principle five focuses on matters pertaining to outward *retakāful* arrangements. That standard discusses the distinction between inward and outward *retakāful* and the different considerations involved.

120. Many issues in the supervision of RTUs are similar to those in the supervision of TUs and have been covered earlier in the present standard. Some aspects of the review of TU/RTUs' *retakāful*/reinsurance programmes have also been covered, particularly those that impact directly on capital adequacy. This section deals with some additional issues, particularly in the supervision of outward *retakāful* arrangements.

121. In reviewing *retakāful*/reinsurance programmes of TUs/RTUs, RSAs need to ensure that the TOs/RTOs have in place a process for subjecting the proposed transactions to appropriate Sharī'ah scrutiny. This is to ensure that the terms of the arrangement are sufficiently clear to permit identification of the contract on which the arrangement is based, and a proper assessment by the Sharī'ah board as to the effectiveness of the arrangement in sharing risk in accordance with Sharī'ah. The RSAs need to ensure that there is clear understanding in the *retakāful* agreement of the business models used in the transaction by all stakeholders involved in the transaction, including the extent to which the arrangement includes proper risk sharing.

122. In ensuring proper attribution of cash flows between funds owned by TOs/RTOs and participant funds under their management, RSAs should examine the TOs/RTOs' policy regarding the attribution of cash flows under *retakāful*/reinsurance contracts entered into by them as cedant or retrocedant, including their justification of that policy. The cash flows covered should include outflows in the form of *retakāful*/reinsurance contributions, *wakālah* fees or other remuneration to the RTOs, and inflows in the form of ceding commission, profit commission, brokerage, recoveries and distribution of surplus from RTUs. RSAs should consider, at a minimum: whether the policy appears to be fair as between stakeholders; whether the policy has received appropriate internal challenge and approval, including from the Sharī'ah board; whether systems and controls appear adequate in design to ensure implementation of the documented policy; and whether there is evidence of testing of those systems and controls to ensure effectiveness. RSAs should also consider whether payments made to intermediaries are correctly attributed and also reflect legitimate payment for activities that are in the best interest of all stakeholders.

3.6 Risk Management

123. IFSB-14: *Standard on Risk Management for Takāful (Islamic Insurance) Undertakings* highlights the key risks that are specific to TUs – that is, Sharī'ah non-compliance risks, risks arising from segregation of funds, and risks relating to the use of *retakāful*. The standard further illustrates the responsibilities and functions of key management functions in ascertaining the effectiveness of the risk management framework.

124. It is the responsibility of the BOD to ensure that an effective risk management framework is established and implemented, and to review its continuing effectiveness.²⁹ In

²⁹ See IFSB-14, paragraph 101.

reviewing the risk management framework operated by a TO/RTO, the RSA should assure itself that the framework is approved by the BOD and is in operation in practice. The RSA should verify the existence of clearly documented processes that are actually carried out in the business, and used daily in the management of the business. The papers and minutes of meetings of the BOD and, where it exists, its Risk Committee will be a valuable tool in doing this, as will interviews with relevant personnel. The RSA may, however, if considered necessary, require provision of an independent report on the risk management framework.

125. RSAs should confirm that the risk management governance functions are carried out by appropriately skilled personnel, appropriate for the functions, who possess adequate authority and resources for the conduct of their functions without restriction and are sufficiently free of conflicting duties to preserve objectivity in carrying out their functions. Review of job descriptions and interview of relevant personnel during the course of on-site supervision may assist RSAs in verifying this.

126. RSAs should check that the risk management framework reflects clear separation of funds between PRF, PIF and SHF, and that risks in each of these funds are identified, assessed and addressed by management based on each fund's distinct nature, function and attribution.

127. Even where an RSA is not specifically responsible for supervision of Sharī'ah compliance, the RSA should expect a TO/RTO's risk management framework to address the risk of non-compliance, as this matter is critical to the TO/RTO's holding itself out as Sharī'ah-compliant. RSAs should therefore review the risk management framework concerning the risk of Sharī'ah non-compliance. RSAs may look for evidence of involvement of the Sharī'ah board in the assessment of these risks, and for the existence and results of a process for testing controls over Sharī'ah compliance. Particular issues arising from the use of *retakāful* are discussed at paragraph 119 above.

128. Regulatory reporting requirements should include reports to the RSA in respect of risk management. These reports should include periodic ORSA reports, as well as reports to the RSA on the occurrence of specified risk events. Where the RSA considers that a TO/RTO's risk management framework is deficient, the RSA should require the TO/RTO to present a plan for remediation of such deficiencies, and to report to the RSA on the implementation of that plan.

3.7 *Takāful and Retakāful Windows*

129. In certain jurisdictions, *takāful/retakāful* windows are allowed to exist within conventional insurance and reinsurance entities. In general, a specific division is established within the conventional entity (referred to here as the “host”), with its own identified assets and liabilities, separate from those of the conventional operation. Normally, *takāful/retakāful* windows must be completely separate from their host conventional insurance/reinsurance operations in terms of capital, accounts, profits and losses by ensuring that their operations are not intertwined with the conventional insurance/reinsurance operation. The losses and profits of each operation (i.e. conventional host and *takāful/retakāful* window) should not be passed to the other. Exceptions to this stipulation are the TO/RTO’s share of profit in its capacity as *mudārib* and the management fee in its capacity as a *wakil*, which can be passed to the conventional host when acting in these capacities.

130. RSAs should be guided by this standard, and by other existing IFSB standards for TOs/RTOs, in supervising such operations. Standards should be applied, with any necessary modifications, to the window as though it were a separate undertaking; and the RSA should pay particular attention to the relationship of the window with the remainder of the undertaking of which it is a part. For example, RSAs should consider whether the window is affected by *retakāful*/reinsurance arrangements that are shared with the host, or by *qard* provided or committed by the host.

131. RSAs should consider whether appropriate Sharī’ah governance is observed (including approval of the arrangements by the *takāful* or *retakāful* window’s Sharī’ah board). Although an RSA may not bear formal responsibility for supervising Sharī’ah compliance, the claim to such compliance is a distinguishing feature of a window as opposed to its conventional host undertaking so far as its customers are concerned. RSAs should confirm that such operations have in place controls designed to secure end-to-end Sharī’ah compliance, and that those controls are tested for effectiveness, with the results of testing reported to senior management.

132. Segregation of funds from those of the host undertaking is a key feature of a *takāful/retakāful* window. The RSA should consider the following: (a) whether the window has adequate policies and processes to prevent the commingling of conventional and *takāful/retakāful* funds; (b) whether the separation of Islamic assets and funds from non-Sharī’ah-compliant assets and funds is transparent; and (c) whether the operation of the window involves features that have the effect of undermining effective segregation. The

system should act not simply to prevent the window from investing in non-Sharī'ah-compliant assets, but also from channelling funds belonging to the *takāful/retakāful* windows back to the conventional host entity (or another conventional party related to it) other than in clearly defined circumstances.

133. In supervising *takāful/retakāful* windows operations, RSAs need to bear in mind the specific characteristics of the window (in particular, Sharī'ah compliance) as well as the fact that it is a distinct part of a conventional institution. If the host institution is required to submit an ORSA, it would be appropriate for this to deal with the window separately, subject to considerations of materiality. Where an RSA is not satisfied that the capital resources available to a window are adequate to reflect its risk profile, the RSA should consider the actions available to it under the regulatory framework to secure mitigation of the perceived risk to the RSA's objectives.

SECTION 4: ADDITIONAL SPECIFIC ISSUES TO BE ADDRESSED UNDER THE SUPERVISORY REVIEW PROCESS OF TAKĀFUL/RETAKĀFUL UNDERTAKINGS

4.1 Group Supervision

134. At the time of preparation of this standard, the application of quantitative requirements at group level is rare in *takāful/retakāful*, though there may be some examples mainly involving conventional groups with relatively small Islamic operations. This section therefore covers supervision only at solo level of the risks to which a *takāful/retakāful* undertaking is exposed as a member of a group, and also other qualitative aspects of group supervision that might fall to be discussed in a supervisory college.

135. An RSA supervising a TU/RTU needs to be aware of the other entities belonging to a group, including operating and non-operating holding companies (including intermediate holding companies); insurers/reinsurers/TUs/RTUs; other regulated entities such as banks or securities companies; non-regulated entities (including parent companies, their subsidiary companies, and companies substantially controlled or managed by entities within the group); and special purpose entities, trusts or funds. The RSA will need to assess the risks such other entities pose to the TU/RTU under its supervision, including through shareholdings, influence, risk concentration; reputational risk, and/or intragroup transactions and exposures (e.g. placement of *retakāful*).

136. An RSA needs to be mindful of risks arising from the group's perspective, which might include: systemic risk; liquidity risks; diversification/concentration; and contagion and reputational risk where *takāful/insurance*, market, credit and operational risks seem to have an adverse impact on certain areas. Particular issues of interest to *takāful/retakāful* supervisors will include the Sharī'ah governance arrangements in place with other group companies with which their undertaking may have significant intragroup transactions, and the extent to which any group-level assessment of capital resources assumes fungibility of the assets held in PRFs or PIFs.

137. Where a group includes undertakings from more than one regulated sector for which a different RSA is responsible, or from different jurisdictions, the RSA of a TU/RTU should expect to cooperate with the RSAs responsible for those other sectors. This cooperation could

be achieved through the appointment of a group-wide supervisor, Memoranda of Understanding, Multilateral Memoranda of Understanding, and/or supervisory colleges. Similar considerations apply where a TO/RTO has operations in other jurisdictions, and the home-state RSA has limited ability to assess the operations and risks arising from those activities. The RSA should establish effective cross-border relationships with supervisors in those other jurisdictions.

138. A supervisory college is normally convened by the group supervisor with the aim of ensuring timely exchange of information between RSAs responsible for group undertakings, identification of risks and coordination of action. RSAs should make themselves aware of the types of group supervision that a TU/RTU is subject to through enquiry of management.

4.2 Conduct of Business

139. The term “conduct of business” in general covers the relationships between a TU/RTU and its customers, including, in particular, the offering and acceptance process, the claims process, and other matters arising during the lifetime of a contract – for example, communications on investment performance. This standard does not deal in detail with the supervisory review process for conduct of business, since the responsibilities of RSAs in this area vary widely and the IFSB has not to date covered the substantive regulation of conduct of business in its standards relating to *takāful/retakāful*.³⁰

140. Although conduct of RTUs in business dealings is an area for consideration by their RSAs, *retakāful* is generally recognised to relate to dealings between professionals who are able to protect their own interests, without direct impact on the protection of consumers as participants. As a consequence, regulators typically apply conduct of business requirements to RTUs only to a limited extent. This section therefore focuses on activities of RSAs with respect to TUs.

141. Many aspects of conduct of business supervision are common to both conventional insurance and *takāful*. In both cases, it is widely recognised that advertising should be fair and not misleading, and that the insurer/TO should not seek to benefit unfairly from the asymmetry in information and financial power between it and the participants. Again, the processes to ensure that claims are handled in a timely and fair manner will be largely common to the two

³⁰ IFSB-9 covers conduct of business for all sectors of Islamic finance, but does not provide a comprehensive framework.

sectors. Similarly, requirements for the provider to “know its customers” in order to manage risks of money laundering and other financial crime apply to both *takāful* and conventional insurance. This section will not elaborate on these areas. The RSAs of TOs, however, need to be mindful of the specificities of the protection of consumers as participants in the *takāful* industry.

142. Where RSAs do have responsibility for conduct of business, especially in the offering and acceptance process, two broad approaches are followed, one based on disclosure and the other on concepts of suitability. The balance between the two approaches varies between jurisdictions, and indeed between types of *takāful*. More stringent requirements are usually imposed for longer-term and investment-based products than for straightforward general *takāful* products such as motor coverage. However, the avoidance of *gharar* means that the contract between the participant and the TU needs to be clear and understandable, and disclose key aspects of the *takāful* relationship, including any relevant fees. Where suitability forms a part of the regime, it must be assumed that a high proportion of *takāful* customers, or potential customers, will be sensitive to Sharī'ah compliance. This sensitivity will need to be taken into account in any assessment of the suitability of competing products. Sharī'ah considerations for *retakāful*, from the perspective of the cedant TU, are discussed above at section 3.5.

143. The RSAs should pay attention to the way claims are handled by TOs. They should ascertain that TOs do not unreasonably reject a claim, and that claims are handled promptly and fairly. RSAs should consider whether TOs provide appropriate and timely information and assistance to help participants make a claim, whether claimants are properly informed of progress, and whether claims are agreed and settled without undue delay. RSAs should also consider whether contracts contain provisions acting as disincentives to make valid claims, or TOs place procedural obstacles to the lodgement or pursuit of claims, and whether proper processes are in place to handle complaints of unfair treatment.

144. Whereas supervisory review in prudential areas is largely top-down and involves looking at governance, systems and controls, and assets and liabilities, in the case of conduct of business the actual experience of participants also plays a significant part. Review of standard documents such as contracts, disclosures and marketing team incentives may therefore be complemented by information such as complaints data and, in some cases, mystery shopper exercises.

4.3 Run-off

145. A TU/RTU goes into run-off when it stops its underwriting activities and operations. A TU/RTU's run-off may be a voluntary business decision, or may be required, either formally or informally, by the RSA. In some cases, a run-off may be limited to certain areas of business, but partial run-offs generally pose much smaller problems than when the whole of an operation is placed into run-off. A TU/RTU in run-off does not end its relationship with existing participants, since the contractual obligation remains for the TO/RTO to pay claims or losses that come due under the *takāful/retakāful* contract. In the case of family *takāful*, this relationship may continue for a very long time, but even in general *takāful* there are likely to be some claims that take a long time to resolve. It may therefore be a considerable time before the full liabilities of the PRF are known precisely. During that period, the TO/RTO has to maintain at least a sufficient administrative operation to pay claims, without income from *wakalah* fees or other fees associated with new underwriting. In some accounting systems, the operation will be regarded as no longer a going concern, and an estimated amount for these future costs will be recognised as a liability in its accounts.

146. In addition, in run-off a TO/RTO has different incentives than when actively underwriting. In particular, it will be less concerned to maintain a high level of financial resources or its reputation with customers. Its financial incentives will be to extract as much money as possible for the benefit of its shareholders, as early as it can. At the same time, the sanctions available to an RSA are very substantially reduced, since the threat to withdraw a licence is now without force. For this reason, although most run-offs are managed entirely properly, supervision is generally difficult.

147. The RSA should require a formal run-off plan from the TU/RTU and ensure that it covers the following issues:

- a. the current and forecast solvency position of both PRF and SHF, taking into account any recognition of business expenses;
- b. the impact on existing and future *retakāful*/reinsurance arrangements;
- c. treatment of *qard* in a run-off, and possible arrangements that may exist to provide additional *qard* should the solvency position of the PRF deteriorate;
- d. the governance arrangements during the run-off period – in particular, in respect of risk management and claims handling; and
- e. the possibilities that may exist to transfer some or all of the undertaking's run-off liabilities to a third-party company.

The run-off plan should be subjected to Sharī'ah review, especially the contractual basis on which any business is transferred.

148. A transfer of business to another TO/RTO may well be an attractive option to protect the interests of participants, especially if that company has other operations that will help to sustain the administrative costs involved. If it does not, however, the RSA will need to be confident that the position of participants will not be worsened by a transfer to a TO/RTO with inadequate financial resources. Arrangements for gaining consent to a transfer will vary between jurisdictions, but it is likely that the RSA will wish to seek a detailed report, including actuarial analysis, that evaluates the impact of transfer on transferring participants and non-transferring participants (if any). The RSA should also consider whether any proposed transfer has been subjected to Sharī'ah review in the transferor and transferee TUs.

149. If there is no transfer, the RSA will need to ensure that the TU/RTU maintains sufficient capital throughout run-off so that the run-off can be executed solvently even under adverse conditions, meeting the undertaking's obligations to its participants. For this reason, the RSA should have power in such circumstances to approve or refuse capital extraction by payment of dividends to shareholders or other means, and by otherwise permissible transfers of resources from the PRF to the SHF.³¹ It should also have the right to approve or refuse any material outsourcing (since excessive fees to outsourced service providers are a known way of extracting resources) and any material intragroup transactions. Should there be a request for capital extraction during run-off, the RSA should not approve this without a proper assessment of the capital position to demonstrate the adequacy of the financial position, after the capital extraction, to the satisfaction of the RSA. The RSA should assess the assumptions on which the forecast capital position is based, and the possibility of deterioration of that capital position, before it makes its decision.

150. Any TU/RTU in run-off should be monitored closely both to ensure that the run-off plan is adhered to and to watch for any deterioration in the TU/RTU's financial position. A solvent run-off can very easily become an insolvent one. At that point, formal resolution arrangements may need to be triggered, whether some form of conservatorship or a court-controlled insolvency procedure. These arrangements are, however, beyond the scope of this standard.

³¹ Transfer of resources from the participants' risk fund to the shareholders fund is permissible in Sharī'ah terms in any of the following three scenarios: (1) SHF recovering the *qard* it provided to the PRF; (2) residual *wakālah* fee; and (3) share of the SHF in its capacity as a *muḍārib* investing the funds of the PRF.

DEFINITIONS

The following definitions explain the terms used in this document. It is not an exhaustive list.

Cedant	The participant in the <i>retakāful</i> contract or in the conventional reinsurance contract, whereby part of the risks are ceded in accordance with the <i>retakāful</i> or reinsurance contract.
Corporate governance	A defined set of relationships between a company's management, its board of directors, shareholders and other stakeholders that provides the structure through which relationships are organised in accordance with the laws, regulations and by-laws of the institution, and requirements of the regulatory and supervisory authorities.
Credit risk	The risk that a counterparty fails to meet its obligations in accordance with agreed terms. Credit risk in a <i>takāful</i> or <i>retakāful</i> undertaking may arise from operational, financing and investment activities of the funds. A similar risk may arise from <i>retakāful</i> or <i>retrotakāful</i> activities of the funds.
Deficiency	The situation where the liabilities of the fund exceed its assets, so that the fund has a debit balance.
Deficit	The situation where claims and other expenses exceed contributions for a financial period.
Host undertaking	A conventional financial services undertaking which operates an Islamic financial services window.
Liquidity risk	The risk of potential loss to the institution arising from its inability either to meet its obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.
Market risk	The risk of losses in on- and off-balance sheet positions arising from movements in market prices – that is, fluctuations in values in tradable, marketable or leasable assets (including <i>ṣukūk</i>) and in off-balance sheet individual portfolios (e.g. restricted investment accounts).
<i>Muḍārabah</i>	A partnership contract between the capital provider (<i>rabb al-māl</i>) and an entrepreneur (<i>muḍārib</i>) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to misconduct, negligence or breach of contracted terms.
Operational risk	The risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. For <i>takāful</i> or <i>retakāful</i> undertakings, this also includes risk of loss resulting from Shari'ah non-compliance and failure in a <i>takāful</i> or <i>retakāful</i> operator's fiduciary responsibilities.
Participants' investment fund	A fund to which a portion of contributions paid by <i>takāful</i> participants is allocated for the purpose of investment and/or savings.
Participants' risk fund	A fund to which a portion of contributions paid by <i>takāful</i> participants is allocated for the purpose of meeting claims by <i>takāful</i> participants on the basis of mutual assistance or protection.

<i>Qard</i>	The payment of money to someone who will benefit from it provided that its equivalent is repaid. The repayment of the money is due at any point in time, even if it is deferred.
<i>Retakāful</i>	An arrangement whereby a <i>takāful</i> undertaking cedes a portion of its risks on the basis of treaty or facultative <i>retakāful</i> as a representative of participants under a <i>takāful</i> contract, whereby it would contribute a portion of the contribution as <i>tabarru'</i> into a common fund to cover against specified loss or damage.
<i>Retakāful</i> operator	Any establishment or entity that manages a <i>retakāful</i> business, usually, though not necessarily, a part of the legal entity in which the participants' interests are held.
<i>Retakāful</i> participant	A party that participates in a <i>retakāful</i> arrangement with the <i>retakāful</i> operator and has the right to benefit under a <i>retakāful</i> contract.
<i>Retakāful</i> risk fund	A fund to which a proportion of contributions paid by cedants to <i>retakāful</i> operators is allocated for the purpose of meeting claims by cedants on the basis of mutual assistance or protection.
<i>Retakāful</i> undertaking	An undertaking operating under the principles of <i>takāful</i> but in which the participants are themselves <i>takāful</i> undertakings and the risks shared are those of the original <i>takāful</i> undertakings' participants.
Risk management	The process whereby the <i>takāful</i> or <i>retakāful</i> undertaking's management takes action to assess and control the impact of past and potential future events that could be detrimental to the undertaking.
Run-off	The situation where a <i>takāful</i> operator no longer undertakes new business for one or more participants' risk funds or <i>retakāful</i> risk funds, but continues to meet those funds' obligations in respect of <i>takāful</i> contracts, including benefits arising from those contracts, until those obligations are fully extinguished.
Shareholders' fund	A fund that represents the assets and liabilities of a <i>takāful</i> or <i>retakāful</i> operator that is not attributable to participants.
Sharī'ah	The practical divine law deduced from its legitimate sources: the Qur'ān, Sunnah, consensus (<i>ijmā'</i>), analogy (<i>qiyās</i>) and other approved sources of the Sharī'ah.
Sharī'ah board	Specific body set up or engaged by an institution offering Islamic financial services to carry out and implement its Sharī'ah governance system.
Solvency requirements	Financial requirements set as part of the solvency regime determining the amounts of solvency resources that a <i>takāful</i> or <i>retakāful</i> undertaking must have in addition to the assets covering its technical provisions and other liabilities.
Stakeholders	Those with a vested interest in the well-being of <i>takāful</i> or <i>retakāful</i> undertakings, including: <ul style="list-style-type: none"> • employees; • <i>takāful</i> participants or cedants under <i>retakāful</i> arrangements; • suppliers; • the community; and • supervisors and governments.
<i>Tabarru'</i>	The amount of contribution that the <i>takāful/retakāful</i> participant commits to donate in order to fulfil the obligation of mutual help in bearing the risks and paying the claims of eligible claimants.

<i>Takāful</i>	A mutual guarantee in return for the commitment to donate an amount in the form of a specified contribution to the participants' risk fund, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks.
<i>Takāful operator</i>	Any establishment or entity that manages a <i>takāful</i> business – usually, though not necessarily, a part of the legal entity in which the participants' interests are held.
<i>Takāful participant</i>	A party that participates in the <i>takāful</i> product with the <i>takāful</i> undertaking and has the right to benefit under a <i>takāful</i> contract.
<i>Takāful undertaking</i>	An undertaking engaged in <i>takāful</i> business in which the participants' risk fund(s) and any participants' investment fund are managed separately from the shareholders' fund (if any) attributable to the <i>takāful</i> operator managing the business.
<i>Takāful/retakāful window</i>	That part of a conventional financial institution (which may be a branch or a dedicated unit of that institution) that provides <i>takāful</i> or <i>retakāful</i> services.
Technical provisions	The value set aside to cover expected obligations arising on <i>takāful</i> or <i>retakāful</i> contracts.
Underwriting	The process of evaluating an application for <i>takāful</i> or <i>retakāful</i> cover, carried out by a <i>takāful</i> or <i>retakāful</i> operator on behalf of the <i>takāful</i> or <i>retakāful</i> participants, to determine the risk associated with an application and decide whether to accept the risk and, if so, on what terms.
Underwriting risk	The risk of loss due to underwriting activities relating to the <i>takāful</i> participants' risk fund or <i>retakāful</i> risk fund. Sources of this risk include assumptions used in pricing or assessment that are subsequently shown to be incorrect by experience of, for example, claims.
Underwriting surplus or deficit	The participants' risk fund's or <i>retakāful</i> risk fund's financial result from the risk elements of its business, being the balance after deducting expenses and claims (including any movement in technical provisions) from the contributions income and adding any investment returns (income and gains on investment assets) attributed to the technical result.
<i>Wakālah</i>	An agency contract where the <i>takāful</i> or <i>retakāful</i> participants (as principal) appoint the <i>takāful</i> or <i>retakāful</i> operator (as agent) to carry out the underwriting and investment activities of the <i>takāful</i> or <i>retakāful</i> funds on their behalf in return for a known fee.