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**ISLAMIC FINANCIAL
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WP-16/12/2020

**REGULATORY AND SUPERVISORY ISSUES IN
TAKAFUL WINDOWS**

Asafa Dauda Adeyinka

December 2020

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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 banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which includes issuing exposure drafts and holding workshops and, where necessary, public hearings. 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.

For more information about the IFSB, please visit www.ifsb.org.

ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AT1	Additional Tier 1
BNM	Bank Negara Malaysia
BOD	Board of Directors
CBB	Central Bank of Bahrain
CET1	Common Equity Tier 1
DFSA	Dubai Financial Services Authority
DIFC	Dubai International Financial Centre
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principles
IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
IFSI	Islamic Financial Services Industry
IIFS	Institution offering Islamic Financial Services
ORSA	Own Risk and Solvency Assessment
PCR	Prescribed Capital Requirement
PIF	Participants' Investment Fund
PRF	Participants' Risk Fund
QFCRA	Qatar Financial Centre Regulatory Authority
RRF	<i>Retakaful</i> Risk Fund
RSA	Regulatory and Supervisory Authority
RTO	<i>Retakāful</i> Operator
RTU	<i>Retakāful</i> Undertaking
SECP	Securities and Exchange Commission Pakistan
SHF	Shareholders' Fund
SSB	Shariah Supervisory Board
STCP	Supplementary Takāful Core Principles
TCP	Takāful Core Principles
TO	<i>Takāful</i> Operator
T1	Tier 1
TU	Takāful Undertakings
UAE	United Arab Emirates
UK	United Kingdom

GLOSSARY

Asset–Liability Matching	The ongoing process of formulating, implementing, monitoring and revising strategies related to assets and liabilities to achieve the financial objectives, given the risk tolerances and other constraints.
Cedant	The participant in the <i>retakāful</i> contract or in the conventional reinsurance contract, to whom 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, 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.
Facultative	A <i>retakāful</i> arrangement that is specific to a single contract (or part of such a contract) written by a <i>takāful</i> undertaking.
<i>Fiqh</i>	Knowledge of the legal rulings pertaining to conduct that have been derived from specific evidence.
Host Insurer	A conventional (re)insurance company undertaking which operates a <i>takāful</i> window.
Institutions offering Islamic Financial Services (IIFS)	Institutions offering Islamic financial services, including Islamic banks, Islamic insurance/ <i>takāful</i> institutions, Islamic windows and Islamic collective investment schemes.
Internal Model	A risk measurement system developed by a <i>takāful</i> operator to analyse its overall risk position, to quantify risks, and to determine the economic capital required to meet those risks.
<i>Kafālah</i>	Adding the liability of the guarantor to that of the guaranteed in settling a debt so that it will be established on both of them.
Liabilities	The financial obligations of both the shareholders' fund and the participants' risk funds/participants' investment funds.
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).
Market-Consistent Valuation	A valuation of the participants' risk fund's assets and liabilities that is consistent with either the assessment of their risk and value by market participants ("mark-to-market" valuation) or, in the absence of a direct market evaluation, the valuation principles, methodologies and risk parameters that market participants would expect to be used ("mark-to-model" valuation).
Minimum Capital Requirements (MCR)	The minimum solvency control level set for the participants' risk fund at which the supervisory authority would invoke its strongest actions, if corrective actions are not implemented.
Minimum Target Capital (MTC)	The minimum solvency control level set for the shareholders' fund at which the supervisory authority would invoke its strongest actions, if corrective actions are not implemented.
<i>Mudārabah</i>	A contract between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur as the <i>muārib</i> (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the <i>mudārabah</i> agreement, while losses are to be borne solely by the capital provider unless they are due to the <i>mudārib</i> 's misconduct, negligence or breach of contracted terms.
Own Risk and Solvency Assessment (ORSA)	A <i>takāful</i> undertaking's assessment of the adequacy of its risk management and current, and likely future, solvency position. Such an assessment should encompass all reasonably foreseeable and relevant material risks, should identify the relationship between risk management and the level and quality of financial resources needed and available, and should determine the overall financial resources the <i>takāful</i> undertaking needs in order to manage its business given its own risk tolerance, business plans and supervisory requirements.
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 Sharī'ah non-compliance and failure in a <i>takāful</i> or <i>retakāful</i> operator's fiduciary responsibilities.
Participants' Investment Fund (PIF)	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 (PRF)	A fund to which contributions paid by <i>takāful</i> participants are allocated for the purpose of meeting claims by <i>takāful</i> participants on the basis of mutual assistance or protection.
Provisions	The amounts set aside on the balance sheet to meet liabilities arising out of <i>takāful</i> or <i>retakāful</i> contracts, including claims provision (whether reported or not), provision for unearned contribution, provision for unexpired risks, <i>takāful</i> or <i>retakāful</i> provision, and other liabilities related to <i>takāful</i> or <i>retakāful</i> contracts (e.g. contributions, deposits and savings accumulated over the term of <i>takāful</i> or <i>retakāful</i> contracts).
Prescribed Capital Requirements (PCR)	The solvency control level set for the participants' risk fund which, if breached, would require action by the <i>takāful</i>

	operator to increase its solvency resources or reduce the risks undertaken by the participants' risk fund.
Prescribed Target Capital (PTC)	The solvency control level set for the shareholders' fund which, if breached, would require action by the <i>takāful</i> operator to increase its capital resources to meet its financial obligation.
<i>Qard</i>	A non-interest-bearing loan intended to allow the borrower to use the funds for a period with the understanding that the loan would be repaid at the end of the period.
Reserves	Amounts set aside to meet unforeseeable liabilities or statutory requirements and stemming either from shareholders' capital or from accumulated surplus.
<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 Operator</i>	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 Participant</i>	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 Undertaking</i>	A <i>takāful</i> company whereby the participants are original <i>takāful</i> companies. It is subjected to the same provisions as a <i>takāful</i> company.
Risk Management	The process whereby the <i>takāful</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. These events can impact both the asset and liability sides of the undertaking's balance sheet, and its cash flow.
Risk Weightings	The assigning of greater importance to particular assets or liabilities based on their risk profiles.
Run-off	The situation where a <i>takāful</i> operator no longer undertakes new business for a participants' risk fund but continues to meet the fund's obligations in respect of in-force <i>takāful</i> contracts until the end of their terms, including benefits arising from those contracts.
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.
<i>Sharī'ah</i>	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 <i>Sharī'ah</i> .
<i>Sharī'ah Non-Compliance Risk</i>	An operational risk resulting from non-compliance of the institution with the rules and principles of <i>Sharī'ah</i> in its products and services.

Solvency Control Levels	Levels of regulatory solvency requirements, which, if breached, trigger restrictions on the <i>takāful</i> operator or interventions by the supervisory authority.
Solvency Requirements	The financial requirements that are set as part of the solvency regime and relate to the determination of amounts of solvency resources that a <i>takāful</i> undertaking must have in addition to the assets covering its technical provisions and other liabilities.
Solvency Resources	The surplus of assets in excess of liabilities that is regarded as available for solvency requirements, in accordance with domestic law or supervisory regulations
<i>Tabarru'</i> Commitment	The amount of contribution to be relinquished by a <i>takāful</i> participant as a donation for fulfilling the obligation of mutual help and to be used to pay claims submitted by 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</i> Operator	Any establishment or entity that manages a <i>takāful</i> business.
<i>Takāful</i> Participant	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/Retakāful</i> Window	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.
<i>Takāful</i> Undertakings	A hybrid structure comprising a <i>takāful</i> operator and one or more underwriting funds (participants' risk funds) that are attributable to the <i>takāful</i> participants.
Technical Provisions	The value set aside to cover expected obligations arising on <i>takāful</i> or <i>retakāful</i> contracts. For solvency purposes, technical provisions comprise two components: <ul style="list-style-type: none"> a. the current central best estimate of the costs of meeting the <i>takāful</i> or <i>retakāful</i> underwriting obligations, discounted to the net present value (current estimate); and b. a margin for risk over the current estimate.
Total Balance Sheet Approach	An approach to assessing the overall financial position of a <i>takāful</i> undertaking that recognises the interdependence between the risks associated with a <i>takāful</i> undertaking's assets, liabilities, regulatory solvency requirements and solvency resources, and the potential impact of those risks upon the <i>takāful</i> undertaking's balance sheet.
Treaty	A <i>retakāful</i> arrangement that covers the whole or part of all contracts written by a <i>takāful</i> undertaking, of a nature specified in the arrangement.
Underwriting	The process of evaluating new applications, carried out by a <i>takāful</i> operator on behalf of the <i>takāful</i> participants

	based on an established set of guidelines to determine the risk associated with an applicant. The <i>takāful</i> operator could accept the application, or assign the appropriate rating class, or decline the application for a <i>takāful</i> contract.
Underwriting Risk	The participants' risk fund's financial outturn from the risk elements of its business, being the balance after deducting expenses and claims (including any movement in provisions for outstanding claims) from the contribution income and adding the investment returns (income and gains on investment assets).
<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.

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EXECUTIVE SUMMARY

The growing demand for Shariah-compliant protection products has prompted an increasing number of conventional insurers to consider offering these products, especially in countries with a sizeable Muslim population. However, the decision to allow the conduct of *takāful* business through a window arrangement is taken by the supervisor in a jurisdiction, and this varies from one jurisdiction to another. While some supervisors view *takāful* windows as a strategy for developing a *takāful* sector, others consider that it puts the development of such a sector at risk.

This paper discusses the basic elements in the regulation and supervision of *takāful* windows; identifies specific issues and challenges, particularly with regards to the applicable principles and benchmarks; and addresses Sharī'ah requirements in the *takāful* operations. It is intended to highlight the challenges encountered by supervisors who are introducing a *takāful* window for the first time and are unfamiliar with some of the procedures and the expertise required in order to supervise this new type of activity.

The paper used an exploratory research design via a questionnaire survey to obtain pertinent information from regulatory and supervisory authorities who are IFSB members. The survey was conducted by the IFSB Secretariat from 19 July to 16 August 2019. The questionnaire covered the scope of supervision of the respondents, and regulatory and supervisory frameworks for the *takāful* sector, with particular reference to *takāful* windows.

The paper documents key results from the survey, with regards to the regulatory toolkit available for the supervision of *takāful* windows, with the purpose of gaining a better understanding of the practices involved, identifying issues and challenges, and providing policy recommendations to enhance supervision. The toolkit includes market entry requirements, as well as key elements of the supervisory review process (market correction) to assess the adequacy of the window's compliance and accountability of organs of governance, where stakeholders' interests and obligations are clarified and understood. In addition, it assists supervisory authorities to develop an integrated system for assessing the governance framework, capital adequacy, risk management framework and *retakāful* programme, as well as addressing other matters relevant to all areas of supervision applicable to *takāful* windows.

The paper draws out issues and challenges arising from the regulation and supervision of *takāful* windows. The different Sharī'ah governance structures and models that have been adopted in various jurisdictions indicate that there is no "single model" or "one-size-fits-all" approach. Findings from the survey also revealed that not all supervisors and operators of *takāful* windows accord due recognition to Sharī'ah compliance, other than their expectation that it will increase their customer numbers and gain them additional market shares. There may be a reputational risk associated with such a practice in the long run if it is left unchecked.

Proportionality allows the jurisdiction's supervisory framework to be applied in a manner appropriate to its legal structure, market conditions and consumers. The proportionality measure taken by the regulatory and supervisory authorities in respect of Sharī'ah governance of *takāful* windows should be appropriate to the size and scale of their operations, and suitable for the jurisdiction's supervisory objectives.

The paramount task for a *takāful* window operator includes managing stakeholders' perceptions and drawing synergy from the established conventional insurers' infrastructure and market position while maintaining the sanctity of *takāful* principles in the operations. In those jurisdictions where *takāful* is still nascent, the supervisory authority should give more attention to the training of qualified personnel with adequate knowledge to drive important aspects of *takāful* business, such as Sharī'ah-compliant investment in and insurance of non-prohibited things to encourage more operators to enter the sector.

In operational terms, it is necessary that an operator ring-fences its *takāful* operation from the host, to prevent conventional activities from mixing (commingling) with those destined for *takāful* operations. This requires an operator to establish capital funds, accounts and reporting systems for the window that are separate from those of the host, even though the existence of an entity (i.e. a *takāful* window) within a legal entity may not be recognised by status in any resolution.

A *takāful* window has the potential to increase its penetration and narrow the protection gap if it is perceived as a transparent and well-regulated activity. The much-needed remedy lies in the effort of regulators and *takāful* operators to develop the market and create public awareness of *takāful* as a financial protection tool. Hence, the key to success will be in attaining a critical size and subsequently spinning off the window from its host, which outcome will depend largely on the availability of sufficient potential customers who are well informed about the opportunities and risks involved.

SECTION 1 INTRODUCTION

1.1 Background

The growing demand for a Shariah-compliant alternative to conventional insurance, especially in countries with a sizeable Muslim population, has prompted an increasing number of conventional insurers in these countries to consider the possibility of offering Shariah-compliant protection products.¹

An organisational arrangement that allows *takāful/retakāful/microtakāful* operations to exist alongside a conventional insurance/reinsurance/microinsurance entity (denoted as the “host” entity) is referred to as a *takāful* window.² Presently, there are an estimated 115 *takāful* windows operating in at least 32 countries, representing nearly 33% of the 353 Islamic insurance entities operating globally in 2019.³

The supervisory regime in a jurisdiction determines the types of institutions (i.e. whether a stand-alone full-fledged *takāful* or a *takāful* window) that are permitted to conduct *takāful*. This depends, however, on supervisors’ views with regard to the systemic development of a *takāful* sector in their jurisdictions.⁴ Consequently, the approach to the formal introduction and regulation of *takāful* varies from one jurisdiction to another. For example, it ranges from jurisdictions whose legislation requires *takāful* to be written only in stand-alone companies (i.e. Brunei, Malaysia, Qatar, Saudi Arabia, Sudan and United Arab Emirates [UAE]⁵) to those whose legislation allows the operation of a *takāful* window alongside the conventional insurers (i.e. Indonesia, Bahrain,⁶ Pakistan,⁷ Turkey,⁸ Singapore, Nigeria, Mauritius,⁹ Kenya,¹⁰ the United Kingdom [UK], and international financial centres¹¹ such as the Labuan International

¹ The emergence of *takāful* (Islamic insurance) in the past four decades, and its continued spread across countries and regions (i.e. the Middle East, South and Central Asia, Europe and Africa) is a response to the growing demand for a Shariah-compliant alternative to conventional insurance, especially in countries with a sizeable Muslim population.

² The term “*takāful*” includes *retakāful* and *microtakāful*, unless otherwise stated or the context requires otherwise.

³ IFSB, *IFSI Stability Report 2020*.

⁴ The term “window” means part of a conventional insurer (which may be a branch or a dedicated unit of that insurer) that provides *takāful* services (other than purely as an intermediary).

⁵ *Takāful*-specific regulation for the local UAE market was introduced in 2010 with a measure called Resolution No. 4, which prohibits conventional insurers from offering *takāful* products via Islamic windows.

⁶ The Central Bank of Bahrain (CBB) Rulebook states that *takāful* and *retakāful* can be established as a branch of a foreign entity resident in Bahrain of a company incorporated under the laws of its territory of incorporation and (where local regulation so requires) authorised as an insurance or reinsurance firm in that territory.

⁷ Under the Securities and Exchange Commission Pakistan (SECP) *Takāful* Rule 2012, conventional insurance companies have been allowed to obtain a licence to start *takāful* window operations.

⁸ The Regulation on the Operating Principles and Procedures of the Participation Insurance came into force in early 2018. According to the regulation, insurance companies can start a window operation simply by informing the supervisory authority.

⁹ Some supervisors allow *takāful* products to be sold within conventional insurance entities even without any specification in the regulations.

¹⁰ The Kenya Insurance Authority has introduced new *takāful* rules that allow the entry of conventional players into the sector. This sees Kenya joining those countries that initially allow *takāful* windows, which enable firms to offer Shariah-compliant and conventional products side-by-side.

¹¹ These Financial Centres have their own civil and commercial laws, and *takāful* regulations different from the relevant laws of the countries in which they reside.

Business and Financial Centre [IBFC] in Malaysia, the Dubai International Finance Centre [DIFC] in the UAE, and the Qatar Financial Centre¹²).

On the other hand, while the supervisory regimes in some jurisdictions that permit *takāful* windows have developmental responsibility for the *takāful* sector, and do exercise it, others do not have such responsibility and perhaps consider that it conflicts with the regulatory functions. With respect to the former, windows provide a platform for take-off and creation of consumers' awareness for *takāful* products and services. It is envisaged that as *takāful* markets grow over time, and achieve a considerable scale in terms of market share (i.e. size of its customer base), the "window" may consider spinning-off into a stand-alone full-fledged *takāful* entity and a subsidiary of an insurance group.¹³

An insurer seeks a *takāful* window licence basically to leverage on its branch network to widen its customer base to reach out to customers with a preference for Shari'ah-compliant products and services. In Pakistan, for instance, the surge in *takāful*'s market share (*takāful* contributions represented 10% of the insurance sector's premiums in 2018),¹⁴ is due largely to the entrance of conventional insurers into the industry as *takāful* operators.¹⁵

The organisational arrangements of *takāful* windows vary widely across countries, ranging from a unit/department of a domestic insurer with extensive branch networks, to the establishment of isolated representative/branch offices of a foreign company aimed at serving niche market segments. Notable examples in this regard are big international insurers opening *takāful* window operations, such as Tokio Marine, AIG, Prudential, HSBC Insurance, Zurich, Munich Re, Swiss Re, Hannover Re, etc.

The Islamic Financial Services Board (IFSB) is increasingly encountering *takāful* window-related issues in its surveillance work and technical assistance. In order to enhance the capacity of the IFSB to service its members in this area, this paper discusses the basic elements in the regulation and supervision of *takāful* windows; identifies issues and challenges specific to the supervision of *takāful* window operations, particularly with regards to the applicable principles and benchmarks for operational differences and gaps in their existing structures; and addresses Sharī'ah requirements in their operations.¹⁶

¹² Financial centres are largely wholesale reinsurance and *retakaful* markets which are prohibited from conducting or retaining *takaful* business.

¹³ In 2014, Otoritas Jasa Keuangan (OJK), Indonesia issued a regulation under which, either by 2024 or (if it occurs earlier) when window *takaful* funds exceed 50% of the insurance funds held, companies are required to split their window business and establish a separate entity. In Turkey, the Regulation on the Operating Principles and Procedures of the Participation Insurance that came in force at the beginning of 2018 stipulates a two-year operating period, which can be extended by the supervisory authority for a further two years until 20 December 2022.

¹⁴ See *Securities and Exchange Commission of Pakistan (SECP) Annual Report, 2018*.

¹⁵ *Takāful* contributions from the window operations in 2018 amounted to USD 172.8 million, which represents 68% of the total contributions, while full-fledged *takāful* operators accounted for more than USD 79.2 million in contributions (IFSB, *IFSI Stability Report 2020*).

¹⁶ IFSB, WP-02: *Evaluation of Core Principles Relevant to Islamic Finance Regulation*, November 2014.

1.2 Objectives

This paper highlights the challenges encountered by supervisory authorities that are introducing a *takāful* window for the first time and are unfamiliar with some of the procedures and the expertise required in order to supervise this new type of activity – in particular, those facing challenges regarding identifying, assessing, monitoring and reporting issues arising from *takāful* window operations.

Generally, this working paper focuses on issues arising from the supervision of *takāful* window operations from a prudential perspective. Specifically, the paper is structured based on the following objectives:

- to review the regulatory framework and supervisory practices with regard to *takāful* window operations across jurisdictions;
- to identify potential issues arising from the current practices regarding *takāful* window operations; and
- to make recommendations on the regulation and supervision of *takāful* windows.

The paper describes the regulatory toolkit available for the supervision of *takāful* windows for the purpose of gaining a better understanding of the practices, issues and challenges, and of providing policy recommendations to enhance its supervision. The available regulatory toolkit includes market entry requirements, and key elements of the supervisory review process (market correction) to assist the supervisory authority to develop an integrated system for assessing the governance framework, capital adequacy, risk management framework and *retakāful* programme, as well as other matters relevant to all areas of supervision applicable to *takāful* windows.

1.3 Methodology and Scope of the Survey

This paper uses the results of a survey conducted by the IFSB Secretariat from 19 July to 16 August 2019¹⁷ to document current practices and approaches to the regulation and supervision of *takāful* window operations. The paper has attempted to describe the basic elements of the regulation and supervision of *takāful* windows, and to identify the challenges to this regulation and supervision arising from the nature of a *takāful* window.

The survey used an exploratory research design via a questionnaire survey to obtain pertinent information from regulatory and supervisory authorities (RSAs) who are IFSB members. The survey questionnaire was distributed via email to 35 IFSB members who are responsible for the supervision of the *takāful* sector.¹⁸ The coverage of the questionnaire included the scope of

¹⁷ Survey Study Report, 3rd Working Group Meeting of the Takaful Core Principles (TCP), *Core Principles for Islamic Finance Regulation (CPIFR) [Takaful Segment]*, 20 September 2019. Kuala Lumpur, Malaysia.

¹⁸ The survey was originally designed for the *Core Principles in Islamic Finance Regulations – Takāful*, as part of the IFSB standard development process, but was adapted for this purpose, given the similarity of some aspect of the survey with the objectives and scope of this paper.

supervision of the respondents, and the regulatory and supervisory framework for the *takāful* sector, with specific reference to *takāful* windows. Key results from the survey are discussed in detail in the succeeding sections.

The questionnaire comprised a combination of both closed-ended and open-ended questions. In addition, most questions were accompanied by additional box space to allow RSAs to add any details or explanations to the answers provided if they wished to do so. This allowed respondents to provide a considerable amount of detail in their answers, and it proved very helpful in analysing the responses and drafting the report.

The Secretariat received responses from 16 (44%) institutions that are responsible for the regulation and supervision of *takāful* sector in 13 countries.¹⁹ Notwithstanding, the responses provide a cross-section of representation in terms of geographical spread and the extent of Islamic finance development and market share. Of the 13 responses, six are from the Middle East region, five from South-East Asia and two from South Asia.

1.4 Structure of the Paper

The remainder of the paper is structured as follows. Section 2 reviews the literature on the approaches to prudential regulation and supervision of *takāful* windows. The review highlights the concept of a window, the features of the regulatory and supervisory framework applicable to *takāful* windows, and reasons behind the varied opinions held by the RSA regarding the accommodation of *takāful* windows. The survey report is presented in section 2.2. Section 3 summarises the findings, and Section 4 discusses recommendations and provides a conclusion.

SECTION 2 PRUDENTIAL REGULATION AND SUPERVISION OF TAKAFUL WINDOWS

2.1 *Takaful* Window: Concept and Regulation

The IFSB Glossary consistently defines the term “*takāful* window” as a part of a conventional financial institution (which may be a branch or a dedicated unit of that institution) that provides *takāful*, *retakāful* (Islamic reinsurance) or *microtakāful* (Islamic microinsurance) services (other than purely as an intermediary), but which does not have a separate legal identity.^{20,21}

¹⁹ Responses were received from more than one institution in some countries.

²⁰ See IFSB Glossary: <https://www.ifsb.org/terminologies.php>

²¹ See section 2.3, paragraph 55, RPED (CPIFR) [Takāful Segment], 5th Working Group Meeting, 23 July 2020.

Where a *takāful* undertaking (TU) takes the form of a window, services or functions that are performed for the window by personnel of the “host” conventional insurer are, from the perspective of the window, outsourced to the host. Although the two are the same legal entity, and it is not possible for the relationship to be set out in a contract, it remains necessary for those responsible for the governance of the window to have a clear view of the scope of the services that are performed for the window and the terms on which they are performed.²² The consideration is in a similar manner to what is applicable in respect of intra-group outsourcing arrangements.

Generally, a *takāful* window is established as a specific division within the “host” conventional entity, with its distinct identified assets and liabilities, separate from those of the conventional operation. *Takāful* windows are completely separated from their host conventional insurance/reinsurance operations in terms of capital, accounts, profits and losses, and their finances/profits are not intertwined with the conventional insurance/reinsurance operation. The losses and profits of each operation (i.e. conventional host and *takāful* window) should not be passed on to the other. Exceptions to this stipulation are the host’s (in its capacity as *takāful/retakāful* operator) share of profit in its capacity as *muqārib* and the management fee in its capacity as a *wakil*, which can be passed to the conventional host when acting in these capacities.²³

IFSB standards²⁴ for the *takāful* sector provide guidance for RSAs to develop their framework for supervising *takāful* operators/*retakāful* operators (TOs/RTOs).²⁵ Similarly, the standards could be applied, with any necessary modifications, to windows; in such a case, particular attention is needed regarding the relationship of the window with the remainder of the insurer of which it is a part.

In attempting to document the regulatory and supervisory approach that IFSB members may wish to consider when developing or reviewing their regulations and guidelines for effective supervision of *takāful* windows, this paper has adopted various approaches. First, it has reviewed standards, exposure drafts and research materials published by the IFSB on the *takāful* sector, plus materials on the regulation and supervision of Islamic banks that are cross-sectoral,²⁶ or are from the International Association of Insurance Supervisors (IAIS)²⁷ or the International Monetary Fund (IMF). Next, a section is dedicated to a discussion of the survey findings with reference to supervision of *takāful* windows in the IFSB members’ jurisdictions. The reviewed extracts and survey findings are then integrated.

²² Section 8.8.7A, RPED (CPIFR) [Takāful Segment], 5th Working Group Meeting, 23 July 2020.

²³ See Section 3.7, IFSB-20 (2019).

²⁴ IFSB-8, IFSB-11, IFSB-14, IFSB-18 and IFSB-20.

²⁵ The term “supervisor” refers to the RSA with responsibility for supervision of the *takāful* industry. Similarly, the term “supervisor” refers to the “regulator”. In this paper, an insurer hosting a *takāful* window is referred to as a “*takāful* operator”.

²⁶ IFSB-9 and IFSB-10.

²⁷ IAIS’s Application Paper on Approaches to Conduct of Intermediaries Supervision.

2.1.1 Features of the Regulatory and Supervisory Framework Applicable to *Takāful* Windows

RSAs that are responsible for supervising the *takāful* sector issue a prudential regulatory and supervisory framework to safeguard their key roles of promoting the soundness and stability of the financial system as a whole, and to safeguard the interests of *takāful* consumers, similar to other sectors, including banking and the capital markets.

In performing their key role, RSAs interface between the *takāful* participants and TOs. The extent to which a supervisor acts in the best interests of consumers is key in building and justifying public trust and confidence in the *takāful* sector.

IFSB prudential standards and guiding principles (i.e., prudential requirements enacted for TOs to enable them to fulfil their contractual commitments to participants) applicable to stand-alone full-fledged TUs are intended to provide supervisory best practices for the *takāful* industry. Standard, to a large extent, can be extended to the supervision of *takāful* windows with any necessary modifications arising from their nature and size.

IFSB-8 provides guidance for RSAs on principles of corporate governance for TOs/RTOs with three main objectives: (i) to reinforce relevant good governance practices consistent with those prescribed by other internationally recognised governance standards; (ii) to strike a balance between the interests and fair treatment of all stakeholders; and (iii) to provide a basis for addressing good governance issues of TUs in the subsequent work of the IFSB on other aspects of regulation – namely, solvency, risk management, disclosure and transparency, conduct of business and the supervisory review process.

The importance of good governance in *takāful* window operations cannot be overemphasised. Even though the overarching objectives of supervision of both a *takāful* window and its host (conventional insurer) are somewhat aligned, the approach and process are typically different. Governance structures and processes appropriate to the nature of a *takāful* window need to consider the typically tripartite relationship between the customer, the *takāful* window and the host insurer to ensure fair treatment of the stakeholders, especially *takāful* customers.

The above considerations should inform the RSA's decision in the evaluation of a *takāful* window's governance structures and processes. It is important for RSAs at the outset to comprehend the ownership structure and operating framework, which should allow for segregation of funds as required by relevant Shari'ah rules and principles. The segregation of the PRF from the TO's shareholders' funds (SHFs) within the window's formation is an important element for consideration in order to ensure understanding of the sources of capital,

for better supervision, and to avoid any chance of commingling of conventional and *takaful* funds.²⁸

With respect to the “board of directors” (BOD), it is also referred to as a “supervisory board”, rather than the “management board” in some jurisdictions that adopt a two-tier system. It is important to ensure that the BOD of the conventional host establishes a clear allocation of responsibilities to various members of management, including the BOD’s committees and the Shari’ah Supervisory Board (SSB), as well as internal and external auditors. However, a good approach to consider may be the formation of a special BOD committee dedicated to the window to ensure better supervision and avoid any chance of commingling of conventional and *takaful* funds.

In relation to the host insurer, supervisors should consider the following: (i) whether the window has adequate policies and processes to prevent the commingling of conventional and *takāful* funds; (ii) whether the separation of Islamic assets and funds from non-Sharī’ah-compliant assets and funds is transparent; and (iii) whether the operation of the window involves features that have the effect of undermining effective segregation.

The assessment of the adequacy of a *takāful* window’s governance framework in light of its risk profile is an important consideration in the evaluation of the governance structure. This can be done through the review of internal policies, procedures, systems and controls. Key considerations are the assessment of the continuing suitability of BOD members, and those in key control functions in particular, in 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 the senior management to account.

Furthermore, it is important to ensure that the BOD of the conventional host establishes a clear allocation of responsibilities to various members of management, including the BOD’s committees and SSB, as well as internal and external auditors.²⁹ In addition, a good approach to consider may be the formation of a special BOD committee dedicated to the window. This approach is capable of addressing the problems of asymmetric information³⁰ and management of conflicts of interest associated with *takāful* entities, which could be amplified in a window operation.

Assessment of the governance framework 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

²⁸ Section 3.7, IFSB-20 (2019).

²⁹ The “board of directors” is also referred to as a “supervisory board”, rather than a “management board”, in some jurisdictions that adopt a two-tier system.

³⁰ Paragraph 21, IFSB-8.

Sharī'ah compliance, the claim to such compliance is a distinguishing feature of a window as opposed to its conventional host, 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.

A TO is required to adhere to the *takāful* core principles (i.e., *ta`awun*,³¹ *tabarru'* commitments³² and the prohibition of *riba*³³). The principles emphasise the sharing of risks among the *takāful* participants, rather than the transfer of risks as in conventional insurers; such risk sharing differentiates a *takāful* window from a conventional insurer and illustrates the rationale for setting up a separate account for underwriting activities on behalf of the *takāful* participants – to conform to the principle of mutuality, while the shareholders' account is still the host insurers.³⁴

Correspondingly, the TO does not take on any underwriting risk; rather, it manages the underwriting, investment and administration of the participants' risk fund (PRF) in line with specified contracts and business models (i.e. *mudarib* or *wakil*, or both). The fiduciary relationships between the TO and *takāful* participants confer the responsibility for providing a *qard* facility on the host insurer in extreme cases when the PRF suffers deficits or a loss.³⁵ It follows that the nature of the fiduciary relationship between the host insurer (who, in this case, is a TO) and *takāful* participants allows, to a certain extent, the capital flow (i.e., in the form of *qard* facility-a form of commingling) with the *takāful* window.³⁶ Thus, the important distinction between a full-fledged *takāful* undertaking and a *takāful* window is that the former is a stand-alone legal entity whose capital is separate from the risk fund, while the operator of a window is a conventional insurer whose capital is commingled with the insurance risk.

2.1.2 Accommodation of Takāful Windows

Takāful entities generally fall into two categories; full-fledged *takāful* undertakings and *takāful* windows. The decision to allow the conduct of *takāful* business through a window arrangement is determined by the supervisor in a jurisdiction, and this may vary from one jurisdiction to another. While some supervisors viewed a *takāful* window as a strategy for the development of

³¹ *Ta`awun*, meaning cooperative or mutual assistance, is another core principle in the operation of *takāful*, with participants agreeing to compensate each other mutually for the losses arising from specified risks.

³² *Tabarru'* commitment is a type of Islamic financial transaction that is fundamental to *takāful* schemes. It is the amount contributed by each *takāful* participant to fulfil obligations of mutual help and to pay claims submitted by eligible claimants. The use of *tabarru'* commitment as the basis of the contributions (premium payments) mitigates the element of *gharar* (lack of certainty in a contract, which may vitiate the contract) in *takāful*.

³³ It is important that investments in both the PRF and the shareholders' funds are *riba*-free types of investment

³⁴ It must be understood that the discussion is in reference to mainstream *takāful* models and practice. Some jurisdictions use different operational models and terms. It is impossible to cover all special cases in their own nomenclatures.

³⁵ IFSB-8 (2009).

³⁶ Ibid.

a *takāful* sector, others consider it as posing a potential risk to the development of a *takāful* sector. The following are some relevant considerations.

Supervisory authorities who permit *takāful* windows noted the following advantages of such an arrangement:

- A *takāful* window benefits from the experience and systems of its host conventional insurer (CI). This might improve the quality of services/products and lower their cost, which could enhance financial inclusion.³⁷ Windows usually have easy access to capital support from the conventional parent.
- A *takāful* window enhances competition in the market, which could lower the cost of providing *takāful* products.
- A *takāful* window could be the only feasible way of providing *takāful* services in countries with a small demand for *takāful* services (i.e. a Muslim-minority population).

Supervisory authorities who frown at *takāful* windows indicated the following risks of such a structure:

- The commingling of a *takāful* window's assets and liabilities with conventional assets and liabilities could pose a significant reputational risk, and may raise issues related to consumer protection. For instance, participants in a *takāful* window scheme may suddenly withdraw their patronage.
- A *takāful* window could hinder the establishment of effective corporate governance and risk management systems. The management and board of a conventional insurer may not be sufficiently attuned to the unique risks inherent in a *takāful* window's activities. As such, their ability to oversee the risk management of the *takāful* window may be compromised. If fit-and-proper criteria for conventional and Islamic finance exist in a CI's operating windows, it is likely that many CIs will be unable to meet these criteria (for the *takāful* window part). Shariah boards might be unable to verify the complete segregation of assets and liabilities.
- The operation of a *takāful* window could open the door for regulatory arbitrage or unfair practices, particularly given the requirements for a clear segregation of the PRF from the insurer's SHFs in a *takāful* window.
- A *takāful* window could hinder effective financial oversight. Some prudential ratios that might be specific to *takāful* could be difficult to monitor appropriately. Windows could also hinder the preparation of proper financial statements for windows activities, which could hinder effective oversight.

³⁷ "Financial inclusion" refers to "a state where individuals and businesses in a society have access to, and usage of, a range of affordable and quality financial products and services that appropriately and justly meet their needs; and that are delivered by formal financial services providers in a transparent and simple manner, enabling informed understanding and decision making by the customer. The ultimate goal of financial inclusion is to enhance the livelihood of beneficiaries while contributing to the overall well-being of the society": IFSB, TN-03.

- The issue of how a distressed *takāful* window should be resolved in accordance with Shariah principles is still under deliberation. This issue is further complicated for a *takāful* window operating within a CI. If the authorities are faced with a distressed CI (with an Islamic *takāful* window), they may not be able to carry out an orderly resolution that satisfies financial stability objectives and Shariah principles that could potentially modify the treatment of the *takāful* window.

2.2 Survey on *Takāful* Windows Supervision

This section presents the findings of a survey on the regulatory and supervisory practices applicable to *takāful* windows conducted for the Working Group on Core Principles for Islamic Finance (Takāful Sector). The survey identified a number of regulations and supervisory guidelines that are generally applicable to both conventional insurers and *takāful* operations. However, the survey discussion focuses on those aspects of the regulations and supervisory guidelines that are largely generic to both *takāful* windows and full-fledged *takāful* undertakings, and specifically apply to *takāful* windows.³⁸

The aim of the survey was to discern how *takāful* windows are being supervised in reality. There are varying practices and approaches to regulation and supervision of *takāful* windows in particular and of the *takāful* sector in general. The survey sought to gather information from respondents on how *takāful* regulations and supervisions fared, and to identify the challenges and any inadequacies.³⁹ As and where the regulations are applicable, the regulatory and supervisory approaches to operating *takāful* windows also form part of the survey responses.

Responses to the survey confirmed that different countries vary in their practices and experiences, which are influenced mainly by the stage of development of the jurisdiction's Islamic finance industry and by its financial development in general. An overview of the scope of supervision and the entities supervised by the respondents is also presented.

2.2.1 Scope of *Takāful* Supervision

Twelve out of 13 respondent RSAs regulate both insurance companies and *takāful* entities and cover a total of 674 entities, of which 67% (451) are conventional undertakings and the remainder (223) are *takāful*, *retakaful* and *microtakaful* undertakings. One respondent was not directly a primary supervising *takāful* operator, but rather an administrator of a *takāful* and insurance benefits protection system.

³⁸The survey was originally conducted as part of the process of developing the IFSB's *Core Principles for Islamic Finance Regulation (CPIFR) [Takāful Standard]* but was adapted for the current purpose because of the similarity in the issues intended to be identified, and the findings have formed the basis of this paper.

³⁹ IFSB-8 (2009).

The respondents' scope of supervision was mainly prudential and conduct of business, with the exception of the government agency that is responsible for administering the *takāful* and insurance benefits protection system. The common scope of supervision of the respondents provides the basis for identifying similar common areas of supervision applicable to *takāful* entities, as well as differences, with a specific focus on *takāful* windows. The survey results indicate that respondents from six jurisdictions (namely, Turkey, Indonesia, Labuan [Malaysia], Pakistan, Dubai [UAE], and Maldives) allow the operation of *takāful* windows. According to this group of respondents, there is no specific regulation for *takāful* windows. The applicable regulations for *takāful* windows are similar to the stand-alone full-fledged TUs.

2.2.2 Licensing Requirements

Licensing requirements are the bedrock of *takāful* sector supervision. Supervisors set licensing requirements to protect their key role in building and justifying public trust and confidence in the *takāful* sector.⁴⁰ Appropriate licensing procedures are necessary market entry requirements, many of which are expected to be complied with on an ongoing basis. Licensing can therefore offer significant advantages to supervisors, by enabling them to have better knowledge of the market and its participants, with specific information on their status and activities.⁴¹

The survey revealed that a licence, or supervisory approval, to operate a window is granted only following due consideration of the required documentation and assessment of the proposed applications. A number of considerations during the approval process include consumer protection, and requirements for appropriate conduct and compliance. Licensing procedures should not constitute unreasonable barriers for applicants seeking to establish a *takāful* window, and should be proportionate to those required for licensing full-fledged *takāful* undertakings.⁴² In one particular jurisdiction, the regulations stipulate that insurance companies can start a window operation simply by informing the supervisory authority.

Six respondents in jurisdictions that permit *takāful* windows noted that an insurer seeking to operate a *takāful* window must be licensed before it can be allowed to do so. Before granting a licence, an insurer seeking to operate a *takāful* window is required to have a business plan setting out the proposed structure and operations of the window and demonstrating an overall level of compliance that the proposed window has (i) effective and transparent segregation of funds and operations from those of the host; (ii) initial funding within the window to demonstrate compliance with requirements for window capital adequacy and liquidity; (iii) effective policies and procedures for risk management at the level of the window; and (iv) effective policies and procedures for Sharī'ah governance of window operations.

⁴⁰ IFSB-8.

⁴¹ IAIS (2016), paragraph 42.

⁴² See paragraphs 127 and 128, RPED, *Core Principles for Islamic Finance Regulation [Takāful Segment]*. IFSB 5th Working Group Meeting, 23 July 2020.

The respondents (in jurisdictions that permit windows) further indicate that their prior approval process takes into account the potential impact on the host of the establishment of a window. Such considerations could, for example, include management of solvency, liquidity risk and other inherent risks arising from the nature of the *takāful* business process; and reliable governance functions (the knowledge and experience of the board and senior management) that ensure ring-fencing of the *takāful* window's assets and funds from its conventional parent in a transparent manner.

Other considerations in relation to this include arrangements by the governance function (board and senior management) of the host to supervise the operations of the window in order to guarantee the following: (i) the integrity of the business process; (ii) the establishment of internal mechanisms procedures and controls; and (iii) the provision of reasonable assurance that the transactions and dealings of the *takāful* windows are in compliance with Shari'ah rules and principles.

2.2.3 Shari'ah Compliance and Governance

"Shari'ah governance framework" refers to the set of structures and processes through which a *takāful* entity ensures that there is effective independent oversight of the Shari'ah compliance of its activities.⁴³ Shari'ah compliance is the practice of observing the set of rules and principles governing institutions offering Islamic financial services (IIFS), including *takāful* entities. Shari'ah governance structure and process are essential aspects of a *takāful* entity, and constitute a part of the broader corporate governance system of the entire conventional insurance legal entity hosting a *takāful* window.

The relevance of a Shari'ah governance structure and process is illustrated by how the Shari'ah governance system complements the existing governance, control and compliance functions within a *takāful* entity, especially with regard to the competence, independence, confidentiality, binding legal effect of Shari'ah pronouncements/resolutions, and consistency with the jurisdictional legal and regulatory framework.⁴⁴

The survey findings duly acknowledged that the Shari'ah governance framework adopted differs among jurisdictions. Supervisors impose different licensing requirements with regards to Shariah compliance. While a majority of the respondents noted that Shariah compliance is a key pre-condition to (and determinant of) whether a proposed request for approval of a *takāful*

⁴³ Independence oversight is the ability to exercise sound judgment after fair consideration of all relevant information and views without influence from management or inappropriate outside interests. The professionalism and independence of the Shari'ah board must be upheld with the highest respect. This concept is further reinforced in IFSB-20.

⁴⁴ IFSB-10 (2009).

window would be considered favourably, two respondents disclosed that their licensing requirements do not address explicitly the issue of Shariah compliance of applicants wishing to establish *takāful* windows.

Four respondents reported that the extant regulations that stipulate their responsibilities do not extend to the recommendation of a particular Sharī`ah governance structure adopted by a *takāful* entity, and its supervision. In this regard, *takāful* entities are free to choose what kind of Sharī`ah governance framework to adopt. This group of respondents is only concerned about the ability of *takāful* entities to have an effective system for managing the reputational risk related to Sharī`ah compliance. It therefore follows that a *takāful* entity should exercise proper discretion in choosing a Sharī`ah governance structure so that it appropriately safeguards the fulfilment of its fiduciary duties, including good faith, care, skill and diligence, towards all its stakeholders.

Five respondents expressed concerns about “market deficiencies” and the need for consumer protection. Therefore, they require that each *takāful* entity should have a proper functioning Sharī`ah governance framework in place, and will seek assurance that this is the case. They also, through a general consultative process untied to any specific Sharī`ah board, issue circulars and directives relating to Sharī`ah-compliant products such as personal accident, medical and health, credit-related endowment, etc.

Four respondents seemed to take the view that Sharī`ah boards have a significant role to play in monitoring the soundness of *takāful* entities, similar to other professional advisers such as lawyers, accountants and auditors. In these jurisdictions, supervisory authorities have their own Sharī`ah board that works together with them in issuing standardised Sharī`ah pronouncements/resolutions, as well as aligning relevant policy and regulatory frameworks with the Sharī`ah.⁴⁵ Although they may be known by different names, such as the National Sharī`ah Advisory Council, National Fatwa Council, High Sharī`ah Board, etc., their functions are similar – that is, to become the highest body issuing Sharī`ah pronouncements/resolutions for the Islamic financial services industry (IFSI) in their country.

The aforementioned confirmed that supervisory authorities tailored the Sharī`ah governance framework to suit market realities; hence, there is no single suitable model. Therefore, it is necessary for supervisors to identify models suitable for their circumstances.

Furthermore, three of those supervising *takāful* windows pointed out that the principle of proportionality is applicable with regards to the requirements for Sharī`ah governance framework for *takāful* windows. According to them, the resources available to the operators of

⁴⁵ Survey Study Report, 3rd Working Group [of the Takaful Core Principles (TCP), *Core Principles for Islamic Finance Regulation (CPIFR) (Takaful Segment)*, 20 September 2019, Kuala Lumpur, Malaysia.

takāful windows relative to their size may be a limiting factor in applying Sharī'ah governance framework functions. Therefore, appropriate guidance may be required to articulate the expectation that *takāful* windows will institute and maintain an adequate Sharī'ah governance framework.

A related issue is the application of “fit and proper” requirements to the appointment of Shariah adviser and personnel involved in window operations. The typical regulatory framework reported by the respondents contains a generic set of fit-and-proper criteria – similar to the assurance sought in appointing their BOD. While five jurisdictions apply fit-and-proper requirements to Shariah board members, other respondents noted that an applicable regulatory framework does not prescribe a distinct and separate set of “fit-and-proper criteria” for Shariah scholars to be appointed to its Shariah board.

With regards to the appointment of Sharī'ah committee members, two respondents expressed concerns that Sharī'ah advisers have adequate knowledge of *fiqh muamalat* together with appropriate understanding of the business of *takāful*. However, one respondent noted that this challenge is being addressed by the application of fit-and-proper requirements, together with requiring the candidate to take up additional training in both *fiqh* and business processes in Islamic finance.

Having a Sharī'ah supervisory board appointed by supervisory authorities will facilitate consistent rulings and decisions, and coordination with those of the Shariah boards of other supervisory agencies within and outside the jurisdiction. This may perhaps be in line with the goal of the two multilateral institutions (i.e. Accounting and Auditing Organization for Islamic Financial Institutions [AAOIFI] and IFSB) of achieving international consistency in Sharī'ah rulings and decisions.

2.2.4 Proportionality in the Supervision of Takāful Windows

The draft *Takāful Core Principles* (TCPs) and *Supplementary Takāful Core Principles* (STCPs) emphasise the concept of proportionality in establishing the minimum requirements for effective supervision of *takāful* entities, including an entity that takes the form of a window.⁴⁶ Accordingly, the principle dictates that the supervisory framework should reflect the nature, scale and complexity of the business process.⁴⁷ This provides an appropriate mechanism for a supervisor to use its judgment in tailoring the application of its supervisory framework to the nature and scale of *takāful* window operations.

⁴⁶ Section 2.3 and paragraph 43, *RPED Core Principles for Islamic Finance Regulation [Takāful Segment]*, 5th Working Group Meeting, 23 July 2020 (online).

⁴⁷ *Realising the Value Proposition of the Takāful Industry for a Stable and Inclusive Financial System*, an IFSB and World Bank joint publication (2017).

Those respondents in jurisdictions that have TUs in the form of *takāful* windows pointed out that the applicable regulatory frameworks do not explicitly take into consideration the nature and size of *takāful* window operations. However, the supervisory framework in their respective jurisdictions recognises proportionality in the supervision of *takāful* window business. Three respondents explained further that proportionality is driven by the supervisory objective, with consideration of size of operations and the nature of the business of *takāful* windows.

According to these respondents, the proportionality principle is applicable in the supervision of *takāful* windows (with consideration of their size) on aspect of the regulations, such as minimum solvency capital requirements; appointment of an actuary, Sharī'ah advisers and a board of directors; and permission to use the infrastructure and functions of the *takāful* operator (host insurer). Window operations may take a variety of forms, so is the applicable principle commensurate with its scale and complexity? For instance, the manner in which the regulation is applied to a *takāful* window differs from how it is applied to a *retakāful* window, due to the complexity of products that the latter offers and the category of customers (mostly financially sophisticated professional or commercial customers).

2.2.5 Supervisory Review and Reporting⁴⁸

“Supervisory review process” refers to the criteria and tools by which a supervisor carries out its supervision.⁴⁹ In the process of developing a supervisory plan, a supervisor will typically analyse the risk initially recognised and its constituent elements. A framework such as this provides supervisors with a structured method for understanding and assessing key risks inherent in a *takāful* undertaking’s activities.

RSAs take various factors into account when deciding the approach to adopt in assessing the adherence of a *takāful* window to relevant regulatory requirements. The survey indicated that the supervisory review process in monitoring *takāful* windows operations may take various forms, including off-site monitoring, on-site inspections or other supervisory tools. The balance between off-site and on-site approaches will typically be influenced by the nature, scale and complexity of windows’ activities, as well as the supervisor’s resources.

The supervisory processes and tools (i.e., off-site surveillance and on-site examination) identified in the survey are consistent with the supervisory review process identified in IFSB-20.⁵⁰ The frameworks highlighted in the standard can be extended to the supervision of *takāful* windows after any necessary modifications to account for the nature and characteristics of the *takāful* window. Thus, the supervisory activities described in the survey are focused on

⁴⁸ In this section, the relevant regulatory and supervisory framework and survey results are discussed together for ease of reference.

⁴⁹ IFSB-20, paragraph 17.

⁵⁰ For details of off-site surveillance and on-site inspection, refer to IFSB-20.

addressing structural issues arising from the characteristics of *takāful* windows. Some of these include:⁵¹

- separation from the *takāful* operator (the host in conventional insurance/reinsurance operations) in terms of capital, accounts, profits and losses;
- supervision of *retakāful*/reinsurance arrangements shared with the host, and *qard* provided or committed by the TO;
- observation of appropriate governance for the window; and
- performance of own risk and solvency assessment (ORSA) separately for the window.

The survey responses indicated that the method adopted varies from jurisdiction to jurisdiction, but takes into account both the potential impact of each risk and the assessed probability that the risk crystallises. According to a majority of the respondents who have responsibility for supervision of *takāful* windows, their supervisory concerns are not limited to, for instance, the need to consider only the risk of the financial failure of a *takāful* window, but include the activities of the host parent, which can sometimes be detrimental to stakeholders (principally, participants) and the market.

Supervisors are concerned with risks that could contribute to the financial failure of an entity. Typical risks are underwriting risk, *retakāful*/reinsurance risk, investment risk, and other risks, such as the conduct of business risk and anti-money laundering/combating the financing of terrorism (AML/CFT) risk. Weighing these disparate risks against each other, and based on considerations of impact and probability in the particular case, the supervisor might choose to devote more resources to managing one risk than the others.⁵²

Supervisors use assessment, such as assigning a ranking or score, to tailor their own activities and interventions in an individual entity. The ranking or score provides the basis and necessary information for the supervisor to conduct effective supervision of *takāful* entities and evaluate the *takāful* market. This, in turn, allows them to allocate appropriate resources to the supervision of an individual *takāful* or *retakāful* entity and to identifying and addressing market-wide issues. More generally, In the context of *takāful*, relevant risks may include risk to public confidence in the Shari'ah integrity of the sector.

Various IFSB standards⁵³ on the *takāful* sector emphasise the “proportionality” principle, which takes into account the size, nature and complexity of a *takāful* undertaking and the characteristics of the environment in which it operates. In such a case, the standards can be extended to TUs in the form of windows. This could either be in the form of a direct *takāful*,

⁵¹ See IFSB-20, section 3.7.

⁵² Ibid

⁵³ IFSB-8, IFSB-11, IFSB-14, IFSB-18 and IFSB-20.

retakāful or *microtakāful*. A similar emphasis is highlighted in the IFSB–IAIS paper that discussed specific issues in the regulation and supervision of *microtakāful*.⁵⁴

Risk-based supervision as described in STCP 9 of the draft document⁵⁵ is a related concept, but distinct from proportionality. A risk-based approach to supervision uses both off-site monitoring and on-site inspections to examine the business of each *takāful* entity; evaluate its financial condition, conduct of business, corporate governance framework, Shari’ah governance framework and overall risk profile; and assess its compliance with relevant legislation and supervisory requirements.

Risk-based supervision (including both on-site examination and off-site monitoring) should be the approach taken to assess a *takāful* entity’s current and prospective solvency, its treatment of customers, and certain other risks. A risk-based framework enables the respondents to assess the risk profile of the *takāful* entity, evaluate its ability to manage and to bear those risks, and seek to detect any issues that may adversely affect the entity’s capacity to meet its obligations towards participants in the long term.

A *takāful* entity’s risk profile is evaluated in respect of its:

- assets and liabilities (including off-balance sheet commitments);
- technical operations (e.g. actuarial methods, underwriting policy, *retakāful*/reinsurance policy);
- 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;
- accounting and internal control systems;
- compliance with supervisory requirements;
- arrangements for business continuity, disaster recovery and succession planning;
- recovery and resolution planning;⁵⁶
- corporate culture and the effectiveness of its corporate governance and risk management; and
- organisational structure and any implications of belonging to a group.

Supervisory Tools

The survey results reflect that while details of the supervisory tools and activities differ somewhat among the RSAs, some supervisory tools and activities are commonly used. The information provided by the respondents is integrated to build an effective framework.

⁵⁴ IFSB–IAIS paper, November 2015.

⁵⁵ Section 2.3 and paragraph 45, RPED, 5th Working Group Meeting, *Core Principles for Islamic Finance Regulation [Takāful Segment]*, 23 July 2020 (online).

⁵⁶ See IFSB WP-07, in particular section 3.4.3, which discusses key recovery issues in *takāful*.

Supervisory Reporting

Supervisors establish documented procedures and guidelines for reporting to secure the desired information.⁵⁷ Access to reliable information allows supervisors to assess the state of each supervised entity, as well as the market more generally. Supervisors specified 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 at the level of the fund (i.e. segregation of funds of *takāful* window) as well as the funds, assets and liabilities of the conventional host.

Granular data on earnings and performance of the window business are segmented according to different types of product, capital and liquidity, additional information on income and expenses, and risk exposures and risk mitigation arrangements. For example, are its risk management processes adequate in the context of the key risks to which it is exposed, and are its earnings, capital and liquidity sufficient to enable it to support its risk profile and withstand unexpected shocks that affect or arise from the SHF, 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.⁵⁸

A number of respondents with the scope for supervising Shari'ah matters noted that their consideration with respect to supervisory reporting includes obtaining periodic statements from the Shari'ah advisory function of the *takāful* window, in addition to more typical statements or certificates from its management or actuaries. The information received facilitates off-site monitoring, allowing the respondents to assess the entity against market information and its own historical performance, and to apply regulatory benchmarks to identify potential indications of emerging problems.

Off-site Monitoring

The survey indicated that respondents performed off-site monitoring or inspection by establishing written procedures for supervisory reporting to be provided by the *takāful* window's operators (i.e. scheduled prudential returns and other returns, ad hoc information requested by the supervisors, information sharing from other supervisors, and information obtained from other relevant sources). The supervisory reports provide the basis for analysis to identify and monitor trends in the industry and within individual *takāful* windows. Off-site monitoring is conducted by individual supervisory staff using monitoring tools and/or by specialised analysts/actuaries, as appropriate. The procedures include those for assessing the valuation of assets, liabilities and technical provisions, such as reviewing and analysing actuarial reports

⁵⁷ See IAIS, Insurance Core Principle (ICP) 8.

⁵⁸ IFSB-20.

and audit reports (whether internal or external) and other reports as necessary, both quantitative and qualitative. The content, format and frequency of the information required will depend on the nature, size and complexity of the undertakings.

Off-site monitoring includes a risk-based analysis of various risks relevant to the *takāful* window, 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. However, it varies according to the scope of the supervisor's responsibility.⁵⁹

On-site Inspection

On-site inspection is conducted by the supervisor at the location of the entity, which may be a *takāful* window. A majority of the respondents noted that on-site inspection of a *takāful* entity is useful as a follow-up on potential risks that have been identified as part of off-site monitoring. It requires the inspector 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. According to a respondent, on-site inspection is usually customised to the particular entity, taking into consideration the nature, scale and complexity of the undertaking. The risk matrix identified during off-site analysis, and the findings of the inspection itself, are elaborated in relation to the information required by the supervisor and provided by the operators. This permits an assessment of whether they comply with the requirements and if there are weaknesses or information to be verified by an on-site inspection.

On-site inspection provides an opportunity for the RSA to have a dialogue with the management on the risk profile of the *takāful* undertaking in relation to its risk-carrying capacity in order to detect any problem that may affect its capacity to meet its obligations towards its stakeholders – primarily, participants – in the long term. It is usual for an RSA to undertake at least the following activities during regular on-site inspections: (i) assessment of the *takāful* window's financial strength, including the valuation of assets, technical provisions and other liabilities in each component of the *takāful* window's funds, and the ability of capital resources in each fund to absorb losses; and (ii) evaluation of the adequacy of any ORSA or similar exercise undertaken by the *takāful* window's management, and conclusions as to the risk profile of the undertaking.⁶⁰

Supervisory Actions and Supervisory Follow-up

Supervisory actions will normally be aimed at mitigating risks. They are usually exercised when a *takāful* window's management's response to supervisory action is judged inadequate, or

⁵⁹ For details of off-site monitoring, see IFSB-20, section 2.2.2.

⁶⁰ For details of on-site monitoring, see IFSB-20, section 2.2.3.

where a breach is so severe that the supervisor considers an enforcement action is warranted. More generally, 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 *takāful* window’s operations. Supervisory actions, where appropriate, should be communicated to the BOD of the conventional parent.

Supervisory follow-up is a necessary process to ensure that a *takāful* window has submitted satisfactory plans to deal with the issues raised by its RSA and has 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 level having been breached.

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:

a. Directions to reinforce financial position:

- requiring measures that reduce or mitigate risks;
- requiring an increase in capital;
- restricting or suspending dividend or other payments to shareholders; and
- similar actions at the level of a PRF to reinforce the financial position of that PRF.

b. Restrictions on business activities:

- prohibiting the *takāful* window from issuing new *takāful* or *retakāful* policies;
- withholding approval for new business activities or acquisitions;
- withholding or withdrawing approval for outsourcing arrangements;
- restricting the transfer of assets; and
- restricting the ownership of subsidiaries.

Various terms are used by the respondents to describe these types of actions. For example, what they mean by “enforcement” varies considerably from one jurisdiction to another. Moreover, there is a distinction between “supervisory follow-up”, which is aimed at obtaining further information or inducing a window operator 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 the management of a window or individuals for failure to maintain compliance.⁶¹

⁶¹ See IFSB-20, sections 2.2.4 and 2.2.5; ICP 11, paragraph 11.2, “Enforcement”.

2.2.6 Disclosure of Information

The IFSB discusses disclosure in *takāful* and *retakāful* windows from the standpoint of the supervisory review process.⁶² RSAs require disclosures of the window's corporate governance framework to demonstrate how the key activities and control functions, including internal control framework, fit into the overall risk management framework.⁶³ In addition, they require disclosure of how the governance framework maintains funds segregation and, at the same time, manages any conflicts of interest arising between parties – in particular, between shareholders and participants.

The nature of a *takāful/retakāful* window calls for proper financial segregation from its operator (host). Thus, there is greater transparency in the window's accounting if the assets and liabilities of the participants and operator are segregated. At the same time, a separate account is maintained between *takāful/retakāful* windows and the *takāful* operator covering assets, liabilities, capital, profits and losses.

For instance, an insurer with window operations shall include the general/family results in its financial statements. In the balance sheet, the total assets and total liabilities of window *takāful* operations shall be disclosed; while in the profit and loss account, the insurer shall disclose a single line item, 'Profit/Loss before taxation from general/family operations. Supporting notes may be included as part of the financial statements where considered necessary for users' understanding. In addition, the insurer shall prepare a separate complete set of financial statements for general/family *takāful* operations as if these are carried out by a stand-alone *takāful* operator and shall form part of the TO's annual/interim report, as applicable.⁶⁴

Many of the disclosure requirements stated in national supervisory framework for takaful entities, are applicable to *takāful/retakāful* windows, or applicable with minor modifications, reflecting the fact that the window is not a legal entity. For example, Section 2 of SECP Takaful rule 2012. Wherever applicable, disclosures from the window should be made as though it were a free-standing TU/RTU. Section 2.3 emphasises the importance of Shari'ah governance disclosures. In addition, disclosures should include the following:

- the arrangements for segregation of funds from those of the host;
- possible flows of funds that may take place between the *takāful/retakāful* window and its host (e.g. a profit-sharing portion and a *wakalah* fee);
- any joint transactions between the window and its host (e.g. joint placement of *retakāful/reinsurance*); and

⁶² See IFSB-20, section 3.7.

⁶³ Detailed Steps in the Revised Exposure Draft, "Disclosures to Promote Transparency and Market Discipline for *Takāful/Retakāful* Undertakings".

⁶⁴ See the SECP *Takaful* rule (2012).

- any arrangements for support from the takaful operator (e.g. *qard*), and any support given in the past and not yet repaid.

It is important that disclosures be timely, relevant and comprehensive in order to give participants and market players a clear view of their business activities, risks, performance and financial position. Such public disclosure of material information is expected to enhance market discipline by providing meaningful and useful information to participants to enable them to make decisions on insuring risks with the *takāful/retakāful* window, and to market players (which includes existing and potential investors and other creditors) to enable them to make decisions about providing resources to the entire entity.

Public disclosure in general-purpose financial reporting may be different from the requirement for regulatory reporting. To the extent that there are differences between the methodologies used in regulatory reporting, such differences should be explained and reconciled where possible. The supervisor should note that a *takāful* operator that provides public general-purpose financial reports may largely comply with jurisdictional disclosure standards.

The draft draws attention to the principle of proportionality, under which the supervisor's application of disclosure requirements will depend on the nature, scale and complexity of undertakings. For example, it may be overly burdensome for *takāful/retakāful* windows to meet the same requirements developed for large, publicly traded TOs/RTOs. While prudential disclosure requirements may vary, the outcome should promote market discipline and provide participants and market players with adequate information for their needs.⁶⁵

Public disclosure may include a description of how information is prepared, including methods applied and assumptions used. Disclosure of methods and assumptions may assist participants and market players in making comparisons between entities. Accounting and actuarial policies, practices and procedures differ not only between jurisdictions but also between TUs/RTUs within the same jurisdiction. Meaningful comparisons can be made only where there is adequate disclosure of how information is prepared.

Similarly, meaningful comparisons from one reporting period to another can be made only if the reader is informed of how the methods and assumptions of preparation have changed and, if practicable, of the impact of that change. Changes over time may not be seen as arbitrary if the reasons for changes in methods and assumptions are explained. If a TO/RTO uses methods and assumptions in the preparation of information which are consistent from period to period, and discloses these, it will assist in the understanding of trends over time.

⁶⁵ Detailed Steps in the Revised Exposure Draft, "Disclosures to Promote Transparency and Market Discipline for *Takāful/Retakāful* Undertakings", section 1.3.

Where changes in methods and assumptions are made, the nature of such changes, the reason for them and their effects, where material, should be disclosed. It may be helpful if information is presented in a manner that facilitates the identification of patterns over time, including providing comparative or corresponding figures from previous periods (e.g. by presenting loss triangulations).

Survey findings revealed that a majority of the respondents that supervise TO/RTO windows set out requirements to be applied to *takāful/retakāful* undertakings (TUs/RTUs), reflecting the core features of *takāful*. These include the models within which TUs/RTUs operate, with multiple funds within a single legal entity, some attributable to participants and some to shareholders, but with financial flows between them. They also include the requirements of Shari'ah governance, including a Shari'ah-compliant investment programme, and the possibility of surplus distributions to participants.

Three respondents reported that the parent insurer that operates TO/RTO windows is required to publish a full separate set of financial statements for its window operation, either in the notes to the financial statements of the conventional insurer of which the *takāful* window is a part, or separately in readily accessible form. In particular, the requirements include that a *takāful* window discloses the following publicly:

- its organisational relationship with the conventional host (i.e. whether the window is established as a division/unit/department or branch of the conventional insurer);
- any arrangements for segregation of funds from those of the operator, and possible flows of funds that may take place between the *takāful* window and its operator host (e.g. profit-sharing portion and *wakalah* fee); plus any joint transactions between the window and its operator (e.g. joint placement of *retakāful*/reinsurance); and
- any arrangements for support from the *takāful* operator (e.g. *qard*), and any support given in the past and not yet repaid.

Two supervisors noted that their policy guide on *takāful* windows stipulates a time limit for the operation and requirements for *takāful* windows to be converted into a TO as a subsidiary. The criteria for requiring conversion are clearly specified (e.g. in terms of asset size of the window, in absolute terms or as a percentage of the parent's balance sheet, years of operation, etc.). Such criteria are clearly grounded in the overall legal and regulatory framework in the jurisdiction as well as its overall strategic plan for the *takāful* industry.

2.2.7 Capital Adequacy

Determination of Solvency Requirements

The focus is on the manner in which the supervisory review process of RSAs addresses those specific characteristics of a *takāful/retakāful* window in the determination of capital requirements. A majority of the respondents use 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 considering the size and scale of the TO/RTU window.

A majority of respondents adopt a total balance sheet approach in the assessment of solvency requirements for a participants' risk fund of a TU. The underwriting funds (i.e. where underwriting activities, and the contributions to which are made on the basis of a *tabarru'* commitment). The balance sheet approach ensures that risks are appropriately recognised and consistently valued, and allows for the interdependence between assets, liabilities, regulatory solvency requirements for PRF and the shareholders' funds of the TO.⁶⁶

A supervisory authority can set the solvency requirements at two specific solvency control levels – namely, prescribed capital requirement (PCR) and minimum capital requirement (MCR). The PCR signifies the highest solvency level that enables the funds to absorb significant unexpected losses, while the MCR signifies a solvency level of which a breach will invoke the strongest regulatory actions. The solvency control levels provide the basis for the supervisory authority to monitor the level of the PCR for a TU/RTU and its PRFs. Any breach of MCR/PCR at the level of the PRF should trigger immediate attention from the TO and the supervisory authority. A set of prompt and proportionate actions could be taken by the TO and the supervisory authority when it is still possible to avert an insolvency position and consequent loss to participants.

As part of the supervisory review process, the supervisor should engage with senior management in the event of concerns that the PCR may become breached in the future, and should put forward a plan acceptable to the supervisory authority to restore the required solvency level within a short period. Where no acceptable plan is put forward and implemented within a reasonable time specified by the supervisory authorities or laid down in law, the undertaking should be prohibited from continuing to write further business.

Moreover, the supervisory authority should consider both the likelihood and impact of failure of the TU/RTU, and subject the TU/RTU 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.

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

⁶⁶ IFSB-11.

RSA considers that a 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.

Available Capital

IFSB-11 provides a basic framework for the supervision of TUs/RTUs with respect to solvency, taking into consideration the segregation of funds that is implicit in the hybrid structure of the *takāful* model. The framework is built on seven key principles premised to achieve four objectives.⁶⁷ Due to the implicit requirement for funds segregation, assets, liabilities and relevant risks are considered at the level of each fund, while taking account of the relationships between funds (e.g., any commitment to provide *qard*⁶⁸).

The application of this standard to a *takāful* window recognises that the TO's funds are directly exposed to substantial insurance risk from the non-*takāful* participants. There may also be a question of whether some of the TO's assets, being non-Shari'ah compliant, can be available for a potential *qard* to the PRF.

Theoretically, a *takāful* operator may merely manage the participants' funds and not accept any insurance risk. However, in many jurisdictions, a TO may be required, whether by regulation or industry practice, to provide financial assistance when there is a deficit in the *takāful* (participants') fund. This assistance is most commonly in the form of *qard al hassan*. There is an expectation that the *takāful* (participants') fund would repay *qard* once there is sufficient surplus.

Takaful model in many of the respondents' jurisdictions recognise the TO's fund to provide *qard*, except in those jurisdictions adopting a cooperative and mutual business model. In these jurisdictions, the *qard* requirement in *takāful* is considered as a regulatory requirement rather than a requirement under Shari'ah. According to this model, participants have no direct control or the ability to influence how a *takāful* fund that belongs to them is being managed. It is the fiduciary duty of the shareholders to exercise an oversight function over the management of a *takāful* fund and that comes with a particular set of responsibilities. In the event of a deficit, there is a certain level of accountability and, in the interest of protecting the participants, *qard* is required as a balancing tool.

Such a practice makes TOs (hosts) effectively responsible for the PRF of *takāful* windows and, to some extent, for the commingling or flow of capital from host conventional insurer to the

⁶⁷ See IFSB-11, paragraph 4.

⁶⁸ *Qard* is an interest-free loan transfer from the *takāful* operator (host) to the PRF and on payment a transfer back. Alternatively, it can be an appropriation of profits from the operator's profit and loss account, thereby reducing the shareholders' equity, and is taken as a capital transfer to the PRF, as additional funding to absorb the deficit.

window's PRF, despite the need to effectively ring-fence the (Sharī'ah-compliant) operations of a window from the (Sharī'ah non-compliant) operations of its host. Nevertheless, *qard* should be repaid if there is a surplus in the *takāful* fund. In jurisdictions where cooperative and mutual business models are practised, there is no requirement on the separation of funds and, as such, the *qard* provision is not applicable. However, the treatment of *qard* creates complexities, especially in determining obligations to participants and shareholders in the event of winding up the PRF. In some jurisdictions, repayment of *qard* is subordinated to participants' and, sometimes, other creditors' claims.

In the supervisory review process, TOs/RTOs are required to maintain a properly documented basis for setting technical provisions for each class or type of business. Based on these documents, the RSA assesses the process of determining appropriate technical provisions separately for each PRF. In appropriate cases, the RSA conducts a proper actuarial review of these provisions and peer group analysis of data and assumptions, and seeks to understand outliers.

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 to 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 implementation of International Financial Reporting Standard (IFRS) 17⁶⁹ dealing with measurement of technical provisions on an economic basis.

RSAs need to ensure that the assets backing the technical provisions or otherwise supporting solvency are correctly valued. Valuation may be a particular issue in TUs/RTUs, and it is advisable that supervisors 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). The illiquidity of most Sharī'ah-compliant assets, such as *sukuk*, may raise the issue of valuation because they 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. This calls for a consistent measurement of assets and liabilities, with identification and measurement of risks

⁶⁹ IFRS 17, *Financial Reporting Standards for Insurance Contracts*.

and their potential impact on all components of the balance sheet. Another important issue to consider is asset–liability mismatches, by duration, currency or location.⁷⁰

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.

Eligibility of Capital

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. A number of solvency regimes (i.e. as revealed in the survey) use a formal “tiering” of capital similar 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.

When a solvency test is applied at the level of the PRF, RSAs need to be conscious of 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. The consideration is applicable to intra-group outsourcing arrangements (i.e. if multiple PRFs are established for different lines of business or, in family *takāful*, when the PRF is separated from a PIF), including *takāful* windows.

Moreover, RSAs should also consider the risk that the ability of capital resources to absorb losses may be undermined by related transactions, encumbrances, or 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.

⁷⁰ IFSB-11, Section B Key Feature 4, paragraph 48-53

In assessing the financial strength of the various funds of TUs/RTUs, RSAs need to be conscious of the kinds of assets that are admissible against the liabilities.⁷¹ At the same time, they need to verify 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. In particular, the RSA will need to understand how *qard* 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.

2.2.8 Surplus Sharing and Distribution

Sharing and Distribution of Underwriting Surplus

Underwriting surplus is the excess of total contributions paid by *takaful* participants during a financial period over the total indemnities paid in respect of claims incurred during the period, net of *retakaful*/reinsurance and after deducting expenses and changes in technical provisions.⁷² The *takaful* participants have exclusive right to the underwriting surplus consistent with several fatwas and Sharī'ah rulings.

The survey highlights the differences among RSAs regarding sharing of an underwriting surplus. While four out of six respondents in jurisdictions that permit the operation of *takaful* windows operate a *takaful* model that permits the sharing of an underwriting surplus, others noted that the sharing of an underwriting surplus is not directly applicable to the *takāful* model in operation. It is noteworthy that the sharing of an investment and underwriting surplus is allowed in jurisdictions where the pure *mudarabah*, *tawuun* (cooperative) and *waqf–mudarabah* models are practised. On the other hand, the distribution of an underwriting surplus (i.e. as a performance fee) is allowed in some jurisdictions that have adopted a pure *wakālah* model. This is in addition to the upfront *wakālah* fees charged to the PRF. Therefore, the *takāful* model in operation in a specific jurisdiction determines whether or not there would be provision for surplus distribution.

Supervisory authorities require *takāful* operators to develop a written policy for determining the surplus or deficit arising from their operations. The basis for determining and allocating that surplus or deficit to the participants, and the method of transferring any surplus or deficit to the participants, must follow the prescribed accounting standard (i.e. IFRS and AAOIFI). For jurisdictions that follow AAOIFI standards, the policy developed must consider all the relevant AAOIFI standards, including Financial Accounting Standard No. 13: *Disclosure of Bases for*

⁷¹ IFSB-11, Key Feature 2: paragraphs 32–36.

⁷² AAOIFI, FAS-13 (2015), p. 497.

Determining and Allocating Surplus or Deficit in Islamic Insurance Companies. This is in addition to the approval granted by the SSB and the BOD of the host (who, in this case, is the *takāful* operator).

Findings from the survey indicated that the majority of the respondents focus on solvency assessment mainly to appraise the strength of the PRF, which invariably would determine the surplus. On whether a surplus distribution can take place prior to the payment of *qard* facility granted by TO's fund, a majority of the respondents in the jurisdictions that supervise window operations allude to the fact that distribution can only take place after reflecting on its impact on the solvency position of the fund. The reason given is that maintaining an adequate solvency position in the PRF is necessary to manage the participants' reasonable expectations.

Reimbursing participants with surplus is much more complex than paying dividends to shareholders, should there be regulations surrounding surplus distribution. (For example, different policies may develop surpluses at different times in their development.) Questions of "substance over form" regarding the admissibility of "takāful windows" need careful consideration

The survey examines the practice of distributing a surplus before the full repayment of a *qard*. Only one jurisdiction has a guideline that permits the distribution of a surplus prior to the full repayment of a *qard*, whereas other respondents have no guidelines on the settlement of a *qard* before any surplus distribution. TOs are left to develop and be guided by their internal policy. One respondent noted that the determination of surplus distribution lies with the board of directors. Thus, they have the discretion to retain or distribute part of, or the entire, surplus depending on the circumstances, with approval from the supervisor.

A *takāful* window operator and its shareholders do not share in the surplus because it belongs to the participants collectively, and must be specified in the *takāful* policy agreement. However, the surplus may be invested for the account of the participants, provided the Sharī'ah provisions regulating such investment are observed. The party undertaking the investment is entitled only to the consideration specified for this purpose (i.e. the percentage of investment profit, in the case of *mudarabah*, or the amount of the fee, in the case of agency). It is noteworthy that in the case of *mudarabah*, only the investment profit is to be shared, not the entire surplus for the period (which includes both the underwriting surplus and the investment profit).

Survey findings highlight the fact that distribution of surplus to the participants can constitute a significant outflow of the PRF. On the other hand, surplus distribution can only properly take place after reflecting on its impact on the solvency position of the fund. The reserve position of the PRF should be the utmost priority of the supervisors. It is suggested that controls on surplus distribution should be introduced, preferably through the corporate governance policies of the *takāful* undertakings, in addition to monitoring by the supervisors. The rule that requires an actuary's indication of the potential impact of surplus distribution on the PRF's solvency position will assist in reprioritising the position of *takāful* operators.

2.2.9 Own Risk and Solvency Assessment (ORSA)

ORSA provides valuable information to the supervisory authority on the status of the undertaking's risk management and solvency position. A number of IFSB standards⁷³ recommend the use of ORSA and capital management processes to monitor and manage the level of a *takāful* undertaking's financial resources relative to its economic capital and the regulatory capital requirements set by the solvency regime.

The survey findings confirm that the responsibility for conducting ORSA rests on the TO/RTO's BOD and senior management agreeing on the validity of the outcome and acting upon its findings. On the other hand, a supervisory authority has the responsibility to consider whether the ORSA has been performed with appropriate governance, including validating that the data, assumptions and parameters used in projecting 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.

The ORSA encompass all the reasonably foreseeable and relevant material risk exposures of an undertaking, 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. 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, SHF and PIF (if any) – as well as for the TU/RTU as a whole, 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.

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.

Stress and scenario testing are a part of the ORSA, involving consideration of how it would be affected by business and economic stresses of various kinds, and by specific loss scenarios (e.g. a major natural disaster affecting an area where it has significant business). Reverse stress testing can also be applied to identify scenarios that would be the likely cause of business

⁷³ IFSB-8, IFSB-11, IFSB-14 and IFSB-20.

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. 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.

The supervisor requires that disclosures about the window's liquidity risk at a fund level (SHF, PRF, PIF) include sufficient quantitative and qualitative information to allow a meaningful assessment. Disclosures should discuss known trends, significant commitments and significant demands. Disclosures should also discuss reasonably foreseeable events that could result in the TU/RTU's liquidity position improving or deteriorating in a material way.

2.2.10 Run-off and Winding-up of Takāful Windows

Run-off

A *takāful* window goes into run-off when it stops its underwriting activities and operations. A window's run-off may be a voluntary business decision, or may be required, either formally or informally, by the supervisor. 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.

The survey revealed that two *retakāful* entities, including a window, are currently under run-off. A *takāful* window in run-off does not end its relationship with existing participants, since the contractual obligation remains for the *takāful* window 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 operator 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.

Moreover, in run-off a window's operator 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.

Supervisory authority should require a formal run-off plan from the TU/RTU and ensure that it covers the following issues:

- the current and forecast solvency position of both PRF and SHF, taking into account any recognition of business expenses;
- the impact on existing and future *retakāful*/reinsurance arrangements;
- 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;
- the governance arrangements during the run-off period in respect of risk management and claims handling and reserving strategy; and
- 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 Shari'ah review, especially in terms of the contractual basis on which any business is transferred.

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 Shari'ah review in the transferor and transferee TUs.

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. 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.

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.

Winding-up of *Takāful* Windows

Winding-up of *takāful* windows from the market requires jurisdictions to set clear procedures in the legislation and to prioritise rights and entitlements of participants in the event that an insurer may want to exit the market. All respondents consent that the procedure for exit from the market is embedded in their respective legislation. Moreover, a majority of the respondents reported that they have guidelines applicable to all forms of exit, including where a *takāful* window operation or branch of a foreign insurer is no longer viable to continue business (i.e. insolvent), when it enters run-off either under distressed conditions or is not financially sound.

As highlighted by the respondents, exit from the market is observed to be in two common forms: voluntary or involuntary exit.

Voluntary exit could be either:

- by surrender of licence to the regulator; or
- through a merger and acquisition exercise. Such transactions are typically subject to the regulator's prior approval, allowing the regulator to exert control in the interest of financial stability.

In terms of priority, six RSAs stated that in their respective jurisdictions, participants have priority over other creditors on winding-up of *takāful* window operations. However, a different view was expressed by a respondent who stated that policyholders/participants rank after preferential debts. The respondents indicated that host insurers are responsible for continuing to administer the PRF and PIF (in the case of family business) upon *takāful* window run-off for payment of liabilities to policyholders and other regulatory obligations.

Involuntary exit may be through insolvent PRF and operators' funds. Persistent deficits erode regulatory capital and eventually lead to insolvency. An insolvent fund can be wound up either through a court order or on direction from the regulator. Insolvency can be due to a prolonged deficit in either or both of the PRF and operators' funds, such that funds are no longer available to act as *qard*.

Some specific areas for insurers hosting a *takāful* window to consider during the winding-up exercise or exit from the market are as follows:

- valuation of assets and liabilities of the PRF and operators' fund, including technical provisions;
- the eligibility of participants to prove debts due to them for each type of debt (e.g. general *takāful* certificate, family *takāful* certificate, investment funds);
- prioritisation of payments by the TO out of *takāful* fund assets to meet the liabilities to *takāful* participants where the assets of a *takāful* fund are insufficient to meet its liabilities; and
- disposition of surplus assets once all liabilities are met.

On the question of the priority of the interests of policyholders (participants, in *takāful*) upon winding-up, the survey responses revealed varying practices. While three RSAs reported that their jurisdiction prioritises due entitlements to staff, creditors and liquidators, two respondents ranked participants above unsecured liabilities, and one respondent indicated that, in its jurisdiction, participants are ranked first in terms of priority for payment upon winding-up. Another respondent reported that the *tabarru'* fund and PIF should only be utilised for payment of liabilities to policyholders.

Although there is nothing to suggest a provision specific to *takāful* windows, the applicable legislation typically provides priority for the rights and entitlements of the policyholders and participants, respectively, upon winding-up. The status of the participant as the owner of the PRF raises different issues during winding-up compared to conventional insurance. These issues include:

- i. *The ownership status of a PRF deficit when qard is no longer possible.* Some jurisdictions restrict the benefits to be shared among participants; however, this disadvantages participants who will not be receiving their full claims. An alternative approach is to ask the participants for contributions to meet the additional cost of claims, so that claimants can receive their entitlements. In this case, a challenge will be communicating and requesting that participants' contributions be paid to defray the deficiency in the fund. In either case, the participants (who are both the owners of the funds and recipients of the claims) end up funding the deficit. The cost of communicating and explaining to all of the participants is likely to be substantial.
- ii. *The ownership status of the PRF surplus in the event that all its liabilities and participants' rights have been fulfilled.* In this case, the surplus no longer belongs to both participants and operator, and its disposition is a suitable subject for regulation in a similar way that a winding-down life fund in conventional insurance can have a tontine effect justifying regulatory intervention.

In conventional insurance, the shareholders can distribute the fund; however, in *takāful* it is challenging to determine the beneficiaries of the participation funds. Various IFSB standards on *takāful* have provided guidance needed to address this challenge.

Regarding the involvement of participants in decision making as the owners of the PRF, only one RSA reported that participants may be involved where necessary in the spirit of mutuality. However, four RSAs provided a contrary view, indicating that participants are not involved in decision making for the winding-up. Two respondents further explained that the content of *takāful* does not allow participants to be involved in decision making, because the PRF is established on the *waqf* model; whereas another RSA stated that the PRF is established on a *tabarru'* contract, which meant that it could only be utilised for the payment of participants' liabilities.

Nine RSAs responded to questions on the disposition of any remaining surplus, including those supervising windows. Three RSAs indicated that there is no explicit requirement in their regulations to deal with this matter. One respondent regulating undertakings established on the *waqf* model requires the surplus of remaining funds (general business) to be disposed of; while for family *takāful*, the disposition of the remaining funds will be decided by the court. Another RSA reported that it was for the court to decide the application of remaining funds.

Two RSAs among nine respondents reported that their jurisdictions had regulations to govern the disposition of any surplus or deficiency remaining in the fund following the settlement of all policyholder liabilities. One reported that in its jurisdiction, a surplus can be used to meet the liabilities of other *takāful* funds managed by the TO that are deficient. Where there is a deficiency, surplus from other *takāful* funds of the operator may be utilised to meet the deficit. In the event of insufficiency, the surplus assets of the shareholders' fund will be used.

Another aspect probed in the survey is the repayment priority or otherwise of *qard* supporting a PRF that would otherwise be in deficiency. Seven RSAs responded to the question on this matter. Three RSAs specified the ranking of *qard*, all differently: one gave *qard* priority after preferential debts; the second ranked *qard* pari passu with all unsecured liabilities of the PRF; and the third allowed repayment of *qard* after all liabilities to participants or proper claimants in respect of that PRF. Two RSAs reported that their regulations have yet to address this matter. One other RSA reported that an insurer operating a *takāful* window should have a clear written policy on the mechanism, including the repayment time period and any impairment of *qard*.

Resolution of *Takāful* Window Operations

Regarding the power of the supervisor on the resolution of *takāful* window operations when no longer viable, the respondents stated that the supervisor has the right to demand the liquidation of the *takāful* window operations from the host insurer and to suspend or revoke its licence for several reasons. Among the reasons identified by respondents is when *takāful* window operations are no longer viable; when Acts, regulations or regulatory instructions have been violated, and when the operation is unable to meet any of its liabilities and to restore its capital to the minimum regulatory requirement. On this ground, it may no longer be permissible for an insurer to continue its *takāful window* business. In addition, two RSAs provided quantitative

indicators, such as losses exceeding 50% of the paid-up capital, and the risk-based capital ratio of the *tabarru'* fund and shareholders' fund dropping below 40%.

2.2.11 Risk Portfolio Transfer, Reassignment and Cessation of Business

Eight RSAs gave their views regarding risk portfolio transfer, including those responsible for the supervision of *takāful* windows. In terms of *takāful* window risk sharing/transfer with conventional Insurance, the respondents expressed different views. One respondent explained that only one model is approved in its jurisdiction (i.e. the *wakalah waqf* model) and hence integration will not be an issue. Another respondent reported that the practice in its jurisdiction was for the transferee to agree to the portfolio being transferred, and for it to be managed in a separate fund where the rights and obligations of participants remain unchanged. However, the issue is whether, upon expiration, the contract/policy renewal could be written to follow the transferee's contractual model.

Five respondent RSAs referred to the regulations, stating that a risk portfolio can only be transferred to another entity with the same type and class of business practised by the transferor entity. Moreover, the RSAs highlighted the procedures that must be followed for the transfer to be consummated, in order to protect the interests of both policyholders and participants under their respective contract/policy. The procedure includes:

- the requirement for the parties involved to submit the proposal for approval;
- performance of solvency assessments; and
- conduct of on-site visits to evaluate and assess the policyholders'/participants' information in the portfolio that will be transferred.

The analysis is expected to highlight how the transfer is to be addressed, and the implications of the transfer for participants/policyholders. An important aspect of the procedure is the requirement for the Sharī'ah advisory committee's approval of all the processes involved. It is required that the advertisement be placed in major newspapers to inform the affected participants/policyholders of the proposed transfer. On the other hand, the QFCRA is of the view that placing an advertisement in the newspaper to inform the affected participants of the proposed transfer would not be sufficient; rather, it emphasises the importance of obtaining the consent of participants prior to the proposed transfer of their contract/policy. For this purpose, all requisite information must be provided to the participants, including the impact on them of such a transfer. Without that consent, the transfer should not happen.

Contrary to the views expressed earlier, two RSAs reported that their guidelines do not permit either cession or acceptance on a risk transfer basis. One RSA did not respond to this question because its institution is currently in consultation on reinsurance instructions with the insurance sector, including some restrictions for *takāful* entities dealing with conventional reinsurance.

Regulations in four jurisdictions restrict the risk transfer and sharing arrangements between *takāful* windows and conventional insurance companies. For such an arrangement to be consummated, it requires explicit approval from the Shari'ah board. For instance, according to three respondents, the regulations require explicit approval of the Shari'ah board for any risk transfer and risk-sharing arrangement. If Shari'ah oversights are to be maintained after the portfolio transfer, the responsibility for Shari'ah compliance is delegated to the Shari'ah committee, whose responsibility is to conduct Shari'ah due diligence with respect to capital and funds components of the *takāful* window and how capital and funds flows between *takāful* window and its conventional host. This is to avoid commingling of funds of the participants' fund with the conventional insurance fund. On the other hand, five RSAs expressed a contrary view which indicates that there is no explicit restriction on *takāful* windows engaging in risk transfer with conventional reinsurance carriers as long as they follow Shari'ah due diligence.

2.2.12 Retakaful and Cross-Border Issues

This section describes the practice of window operations/representative office branches of foreign reinsurers conducting inward *retakāful* activities, according to those RSAs who participated in the survey. *Retakaful* entities other than stand-alone ones can be in the form of window operations or by way of a branch of a foreign reinsurer. A number of national supervisors and international financial centres supervise wholesale *retakaful* entities, many of which are *retakaful* windows/or representative branch offices of foreign reinsurers conducting *retakaful* business. These RSAs have a set of laws and regulatory frameworks governing *retakaful* windows business, in particular as related to governance, financial soundness and reporting in respect of licensed *retakaful* windows and *takaful* branches of foreign reinsurers (i.e. the CBB Rulebook Capital Adequacy module; QFC Prudential Insurance Rulebook; and Dubai Financial Services Authority's [DFSA] Islamic Financial Rule module).

The discussion here highlights relevant aspects of *retakaful* arrangements needed to ensure that the interests of the stakeholders are appropriately preserved and, of course, with consideration for window operations.

The nature of the participants is the key differentiating element between *retakāful* and *takāful*, otherwise they are conceptually similar. *Retakāful* participants are mainly *takaful* undertakings, whereas *takāful* participants are individuals, groups, businesses and various other organisations. These participant TUs or RTUs, referred to as cedants, contribute a sum of money from their respective PRF or cedant *retakāful* risk fund (RRF) as a *tabarru'* into a common fund that is managed by the receiving RTO. The common fund will be used to assist the cedants' PRFs or RRFs against a specified type of loss or damage.

The importance of *retakaful* business has been increasingly appreciated in recent years, due to its substantial absorption of catastrophic losses from various man-made and natural events. *Retakaful* is recognised as a mechanism that help TUs spread their risks over time, across geographical locations, and through different lines of business. The international dimension of *retakāful* business requires diversification of risk across different markets, and the need to avoid concentration of credit risk. This provides the necessary impetus for supervisors to license *takāful* windows and *takaful* branches of foreign reinsurers to conduct *retakaful* business. While these requirements highlight the importance of establishing *retakāful* windows, it is important that the operators of *retakāful* windows or *retakāful* branches of foreign reinsurers subject themselves to the prevailing jurisdictional laws and regulations governing their operation.

The aim of licensing of *retakāful* windows/representative branch offices is to create a reliable *retakāful* entity capable of filling the gap in the market, building capacity and contributing to the development of the *takāful* industry. The licensing of *retakaful* windows and the establishment of representative offices of *retakāful* branches of overseas reinsurers should be done in a manner that enhances the availability of *retakāful* to the local direct *takaful* market. Supervisors are therefore required to consider the appropriateness of the foreign reinsurers with whom cedants (i.e. TUs) propose to arrange *retakāful* cover. In addition, the consideration should include the financial stability implications in accepting risks from their markets. On the other hand, the supervisors of foreign reinsurers need to consider the prudential implications of foreign reinsurers arising from overseas operations and incoming business.

Regulatory approaches should therefore consider specific actions focused on monitoring the quality of *retakaful* entities (especially *retakaful* windows and the establishment of representative offices of *retakāful* branches of overseas reinsurers) that participate in the domestic market – in particular, with regards to appropriate risk management, governance internal control systems and disclosure of specific information to the regulatory body. The approach may include requirement to be registered as a representative office, to submit annual financial reports or rating agencies' statements and to appoint an external auditor within the host jurisdiction.⁷⁴

Findings from the survey further highlight some cross-border issues of concern to the participants, who urged the IFSB to direct their future efforts towards clarifying, in particular, core principles for *takāful*. The participants mentioned specifically that *retakaful* windows or *retakaful* branches of overseas reinsurers are issues that the *takaful* RSAs have necessarily to deal with, in order to promote the development of *takaful* markets. The issue is particularly related to the treatment of cedants (TUs) by the *retakaful* branch or windows of overseas reinsurers regarding the adoption of different Sharī'ah models. Cross-border

⁷⁴ IFSB-18.

retakāful/reinsurance agreements for *takāful* operators should be clarified with regards to Sharī'ah compliance, in the interest of transparency and providing correct information to the stakeholders. There is also a need to develop and improvise standards for reinsurers operating *takāful* windows, particularly in relation to the concern for information asymmetry, in the interest of transparency and market discipline.

Other relevant issues highlighted in the survey include the need for a supervisory framework to recognise *retakaful* characteristics with regard to technical provisions, investments and liquidity, capital requirements, and corporate governance (policies regarding risk management and control), in addition to the need for an exchange of information between supervisors and for the establishment of a database on *retakaful*.

Large and Specialised Risks

Cross-border supply of *retakaful* coverage through windows or representative branch offices of foreign reinsurers has brought serious capacity building that makes possible coverage of large and specialised risks. Such risks were hitherto usually exported to international financial centres (i.e. London and European markets) after local cedants retained single-digit percentages, or were altogether exported against a risk-free fronting fee.

International reinsurers conducting *retakaful* business in the form of windows or branches are perceived as possessing technical expertise capable of underwriting specialty risks in certain lines of business, such as marine (hull and cargo), aviation, space, energy and property, and liability risks of significant dimension where individual risks often exceed the capacity of TUs.

These entities (i.e. *retakaful* windows or *retakaful* branches of foreign reinsurers) are more relevant due to the fact that they bring to the *retakāful* sector their technical expertise and experience in underwriting such specialised risks. TUs rely on *retakāful* to reduce the volatility of the risk they retain; by doing so, they are able to manage their own capital requirements and to increase their capacity to accept new business and expand their *takāful* operations.

Retakaful windows/branches of foreign reinsurers, on the other hand, provide additional financial strengths and technical underwriting capability for TUs to manage their risk exposures. In most cases, TUs rely upon the aforementioned attributes when considering whether to underwrite such risks as primary providers, and indeed ensure that they have a suitable formal *retakaful* agreement before accepting any underlying contract.

Capital-Intensive Nature of the Business

One of the key considerations for the establishment of windows and *retakaful* windows/ branch offices of overseas reinsurers is the large amounts of capital required for operations. Regulation has increasingly focused on capital requirements due to the capital-intensive nature of the *retakāful* business. Thus, the requirement creates the need to hold capital to cope with the exposures that it assumes to events of low frequency but high severity, or to provide effective relief for new business strains of cedants. It is understandable that the capital needs can be optimised by maintaining a very well diversified book of business.

Retakaful windows/*retakaful* branches of overseas reinsurers are better placed due to financial access and technical expertise from their parent. From a financial perspective, the decision of TUs to place their risks in a bigger pool of diversified risks gives them more financial security and more room to manoeuvre. Good credit quality is an additional requirement, such as providing security in trust, at least equal to the technical provision for the business/risk originating from the jurisdiction. This invariably represents a realistic counterparty, enabling it to accept and retain large tranches of exposures.

Sharī`ah Compliance of Business Accepted

The international nature of *retakāful* business, and the fallout of many small risks that may be bundled into a single treaty, could prompt the operators of a *retakāful* window to accept business that is not Sharī`ah-compliant. In most cases, being a wholesale risk carrier, it may be impracticable for the operators of a *retakāful* window/branch to perform independent Sharī`ah assessment of each and every risk that is presented by cedants. Thus, they rely on the Sharī`ah governance function of cedants. The operation of *retakāful* windows carries additional issues that may require the supervisor's attention. The close association with a conventional reinsurance operation requires monitoring of operations to ensure Sharī`ah compliance is not compromised. Assessing and demonstrating the window's compliance with applicable principles may require particular attention if the RRF is likely to be dependent, on more than an exceptional basis, on capital support from funds that are not invested in a Sharī`ah-compliant way.

Even in a situation where the Sharī`ah governance functions of the cedant are sound, there may be the possibility of a risk of different interpretations of the application of Sharī`ah principles between cedants and a *retakāful* window operator. For instance, a *retakāful* window operator may rely on a representation for acceptance of an arrangement, but be unaware at the time that the arrangement is not in fact compliant based on the understanding of its own Sharī`ah governance function. On the other hand, it is also possible, in the case of treaty *retakāful*, that non-compliant elements are inadvertently contained in aggregations of otherwise compliant

risks bundled together for cession. It is therefore important that *retakāful* window operators weigh the implications of accepting business that is not Sharī'ah-compliant, and the mechanisms that are available to it for managing the risk of so doing and for identifying and purifying income that arises as a result.

Dealing with the Run-off

A *retakāful* window operation may go into run-off, and may cease to accept new business while continuing to pay claims arising from existing contracts. Run-off may relate to part of the business or to the whole, and may in some circumstances be required by the RSA, usually in response to a deteriorating solvency position.

Run-off creates a new set of risks and incentives, which may be exacerbated for a *retakāful* window by three factors:

- the time taken to run off the business is likely to be long, because of the indirect relationship with ultimate participants;
- given that the RRF is attributable to the participants, who will reduce in number as their claims are met, there may be a need to determine how any residual assets are allocated at the end of the period; and
- an unscrupulous *retakāful* operator might seek to extract value from the RRF for the benefit of its SHF – for example, by manipulating the charges that it is entitled to make under the relevant contracts.

With the run-off, the direct TU will lose treaty and facultative support, and its technical adviser. The run-off decision may have been avoided if the *retakāful* window operator has a viable restructuring plan for a specified period detailing a fresh strategy and vision. Therefore, an operator must factor in economic and financial volatility in their markets, in addition to anticipating natural hazards of varying severity and frequency.

Supplementary Services

As is also the case in the conventional reinsurance industry, a *retakāful* window may provide ancillary services to cedants and to other parties that are connected with the business of *retakāful* but which do not constitute *retakāful* contracts themselves. Such services could, for example, include statistical or actuarial services, risk analysis or research. The provision of such services may be complementary, but also important to the interests of cedants. The *retakāful* window's risk management procedures need to encompass risks arising from such activities, including any potential conflicts.

Given the distinct governance and risk management framework that will be required of the *takāful* branches of foreign reinsurers, supervisors need to ensure that operational and legal risks are appropriately managed and that the *retakāful* arrangements are subject to more intrusive supervision, specifically in respect of their legal certainty, effectiveness and enforceability.

2.2.13 Other Issues Related to the Supervision of Takāful Entities

The respondent RSAs view that pre-conditions for effective supervision of *takāful* entities should align with the core principles for *takāful* with an emphasis on the avoidance of *riba* and *gharar* in all related operations. According to all respondents, having a functional Sharī'ah framework is a necessary condition to guarantee Sharī'ah compliance of all *takāful* entities' operations. This includes Sharī'ah infrastructure and governance at both the national and entity levels.

One RSA mentioned enhancing financial inclusion through the *takāful* sector as part of the supervisory objectives. Other considerations include the need to provide a globally accepted regulatory/supervisory framework for the Islamic insurance sector, and to have guidance on protection of policyholders' and beneficiaries' rights.

Conflicts of Interest

A *takāful* window is just another product in the host insurer. As such, there are bound to be conflicts of interest. The following scenarios were identified in the survey:

- Concerns about cannibalisation of the more profitable (from a shareholder's perspective) insurance products preventing the *takāful* window developing beyond certain stage.
- Allocation of marketing efforts and resources between *takāful* and insurance. Which products should management give priority to when marketing?
- Allocation of Sharī'ah-compliant assets. (Insurers also invest in Sharī'ah-compliant assets.) For example, if a particular Sharī'ah-compliant asset is desirable for both *takāful* and insurance, where would management allocate this asset?
- Allocation of expenses between *takāful* and insurance businesses. Due to the different ways in which expenses are offset in *takāful* and insurance, allocation of expenses affects shareholders' profitability differently, giving rise to governance issues.

- Greater mis-selling risks, as the same sales workforce/distribution channels would probably be used for *takāful* and insurance and sales staff may have only limited understanding of *takāful*.
- Notional or physical separation of assets between the window and insurance? Notional separation raises issues on any winding-up.
- In any winding-up, how would the *takāful* window be treated?
- What issues are there relating to market risk?

Policyholder Protection Fund

Only two jurisdictions provide participants with a protection fund that is operated in line with Sharī'ah principles. Policyholder protection funds do not typically take a Sharī'ah-compliant form, which may be problematic. The possibility does exist, however, for compliant models such as the *kafālah*, *takāful* and *wakālah* models.

SECTION 3 SUMMARY OF FINDINGS

In reference to the IFSB's survey conducted in 2019, the experience and views of RSAs who have introduced *takāful* windows over a period of time were drawn on to help us to understand the practices regarding the supervision of licensed *takāful* and *retakāful* windows, and to underscore the issues and challenges arising from the practices.

Indeed, RSAs in a number of jurisdictions have taken up the role of developing the *takāful* sector. From the development perspective, a supervisor would have to decide how it envisages the *takāful* sector developing over the long term. Policy decisions on whether (and when) to phase them out, however, depend on the supervisory objectives.

As a result, they considered opening *takāful/retakāful* windows as a take-off platform to create awareness and penetrate the market. Once the activities of the windows operated over time have achieved a considerable scale and gathered a sizeable customer base for *takāful* operations, there is consideration to spin-off *takāful* windows into a separate subsidiary, or even to fully convert them into a full-fledged Islamic entity. In this sense, the role of the supervisor is critical in fostering an environment that supports systematic development of the *takāful* sector.

Based on the survey report, the supervisory authority in a particular jurisdiction determines what forms of *takāful* window operation are permitted to operate, and this varies from one jurisdiction to another. Supervisors that permit *takāful* windows must satisfy themselves that the insurer offering such windows has the internal systems, procedures and controls designed to manage

risks and corporate governance challenges presented by the *takāful* windows. The following are some issues raised in regards to supervision of *takāful* windows:

- The transactions and dealings of the *takāful* windows are in compliance with applicable Sharī'ah rules and principles.
- Appropriate risk management policies and practices are followed.
- Islamic and non-Islamic business are properly segregated.
- The insurer provides adequate disclosures for its *takāful* window operations.

Supervisors require windows to have appropriate corporate governance, which may be different from the stand-alone full-fledge TUs (as is the case for many of the requirements discussed in this paper). Due to the small size of windows, it may not be appropriate to apply corporate governance and internal control requirements to them in the same manner as to TUs/RTUs. Nevertheless, it is critical that supervisors resolve issues – in particular, regarding the segregation of capital funds allocated to *takāful/retakāful* windows – in order to achieve a minimum standard of governance, especially in relation to the segregation of shareholders' and policyholders' funds and the financial support of the SHF in case of a deficit in the *takāful* window operations.

A specific issue for *takāful* windows' operators is the implementing governance framework to accommodate the different incentives and interests of its disparate stakeholders for its SHF and PRF/PIF. A clear separation of responsibilities towards each fund requires careful consideration to avoid any conflict of interest.

From the organisational perspective, corporate governance is concerned with the framework under which a window is managed, as well as with the roles and responsibilities of those accountable for its management. The essential elements of corporate governance for *takāful* as set out in IFSB-8 are meant, among other things, to represent the rights and interests, and provide for the obligations of, *takāful/retakāful* participants; and to adopt and implement procedures for appropriate disclosures that provide *takāful* participants with fair access to material and relevant information.

A supervisory authority should have an understanding of the policy of a window's operator 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.

The survey revealed that not all conventional insurers who operate a *takaful* window accord due recognition to Shariah compliance, other than their expectation to increase the customer base and gain additional market share. This is particularly the case in the emerging *takaful* markets; if the practice is unchecked, in the long run, there may be reputational risk associated with it. Related to this is the insufficient number of qualified personnel needed to drive the *takaful* business. Invariably, personnel with a conventional mindset are often hired to drive *takaful* business. It is important for the regulatory and supervisory authorities to have a dedicated Shariah governance in relation to *takaful/retakaful* windows, consistent with the existing Shariah governance for full-fledged *takaful/retakaful* operators.

Moreover, the survey findings recognised that Sharī'ah advisory functions may vary according to organisational forms, as well as 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. However, depending on the scale and size of the operations, there is a need to apply Sharī'ah governance that is appropriate to the *takāful* windows to supervise Sharī'ah requirements, an element that distinguishes it from its host conventional insurer.

Supervisors in different jurisdictions adopt different Sharī'ah governance arrangements, principles and rulings (fatwa). Thus, practices that are permissible in some countries could be deemed non-permissible in others. The fact that supervisory bodies in different countries tend to rely on their own Shariah scholars may result in contradictory statements regarding the acceptability of a given instrument. Such a disparity could discourage the cross-border use of Islamic products and constrain the industry's growth potential. It could also result in pernicious regulatory arbitrage. To this extent, many supervisory authorities that have newly introduced *takāful* windows into the market find it difficult to adopt one of several Sharī'ah principles and policies enacted by various jurisdictions.

It is necessary that a conventional insurer operating a *takāful* window ring-fences *takāful* operations to prevent conventional activities from mixing (commingling) with those destined for *takāful* operations. In operational terms, this requires the insurer that is operating the *takāful* window to establish different capital funds, accounts and reporting systems for each type of activity. However, the existence of an entity (i.e., a *takāful* window) within a legal entity may not be recognised by status in any resolution.

The challenges of window operations include its accounting treatment and the managing stakeholders' perceptions. The paramount task is drawing synergy from the established conventional insurance companies' infrastructure and market position while maintaining the sanctity of *takaful* principles in the operations. Related to this is financial reporting of *takāful* windows' operations.

Since the legal entity carrying out a *takāful* window operation is the insurer, it is necessary to present the statement of financial position and the results of operations as a single entity. The

nature of the *takaful* operations in accordance with Shariah is different from the conventional insurer activities; accordingly, the content of financial statements of a general/family *takaful* operation are also distinct from the insurer's conventional business.

In respect to the above, it should be noted that the *takaful* operator shall prepare statements of financial position in a columnar format for presenting the SHF and PRF separately, with a combined statement of comprehensive Income of the SHF and PRF showing the two separately within a single statement. In the case of family *takaful*, the financial statements are complex, which complexity has increased further with the introduction of windows.⁷⁵

Accordingly, *takāful* operations must be carried out separately from other insurance business of the host insurer. The presentation of separate complete sets of financial statements is therefore necessary to ensure that information is available and comparable for the participants in *takāful* undertakings and other stakeholders. The challenges are related to the accounting treatments, and to management stakeholders' perceptions of the contents of financial statements of *takāful* operations (i.e. general/family *takāful*), which are distinct from the insurer's conventional insurance business.

A related issue in assessing the capital adequacy of the conventional insurer concerned is the treatment of Sharī'ah-compliant assets and the risk-bearing nature of assets invested for each fund of the window. Assessment of the respective funds is to be done in a manner that ensures capital and liquidity are made available to *takāful* windows, and that losses generated by the windows will eventually be absorbed. An issue may arise due to the cross-border development nature of *takāful* window operations when a conventional insurer (parent entity) of a *takāful* window operation is situated in another jurisdiction and there are restrictions on, or impediments to, fund transfers between the parent and the window.

The supervisory review assesses the adequacy of the window's compliance and accountability of organs of governance, where stakeholders' interests and obligations are clarified and understood. Some RSAs issue specific guidelines on the maximum allowable fee structure or the fee calculation mechanism for the various *takāful* models applicable, the sharing of profits (e.g. from investments made under a *muḍarabah* agreement) and any performance-related incentive. This should be clearly specified in the contractual structure with participants and have been approved by the Sharī'ah adviser (as in the case of windows). RSAs should check that the contractual structure is strictly adhered to.

⁷⁵ Detailed Steps in the Revised Exposure Draft, "Disclosures to Promote Transparency and Market Discipline for Takāful/Retakāful Undertakings".

SECTION 4 CONCLUSION AND RECOMMENDATIONS

Takāful windows could be a channel to promote the orderly development and growth of the *takāful* sector in circumstances where *takāful* is still new in the market, by allowing new entrants in the form of *takāful* windows into the sector. Indonesia, Pakistan and Turkey are good illustrations of where *takāful* windows have become the driver of growth. In addition, licensing of *takāful* windows has provided insurers with an opportunity to learn about the *takāful* concept without necessarily having to put in the huge investment needed to set up a new company. This is consistent with the goal of *takāful* supervision, such as to keep the *takāful* market sufficiently efficient and open to new entrants and competition.

Takāful windows offer the benefit of cost advantages by drawing synergy from the established conventional insurer host's infrastructure and market position while maintaining the sanctity of *takāful* principles in letter and spirit. The advantage is more obvious in markets where Muslims are a minority. A conventional insurer offering Sharī'ah-compliant protection products and services through a *takāful* window could help to cater for customers' desire for such products and services at reduced marginal costs.

Takāful windows have the potential to increase *takāful* penetration and to narrow the protection gap, depending on whether *takāful* windows are perceived as a transparent and well-regulated activity. The much-needed remedy lies in the effort of regulators and *takāful* operators to develop the market and create public awareness of *takāful* as a financial protection tool. Hence, a key success factor lies in attaining critical size and subsequent spin-off from its host. This will largely depend on the availability of potential customers who are well-informed about the opportunities and risks involved.

It is recommended that supervisors consider adding a spinning-off condition to the licensing of *takāful* windows by requesting them to convert to a full-fledged *takāful* operator within a prescribed period. This spinning-off plan should be submitted to the supervisory authorities. The IFSB may provide general guiding principles; however, the detailed related conditions may be left to the concerned regulatory authorities, based on their own assessment of the scale and size of development of the *takāful* sector in their respective jurisdiction. *Takāful* windows or branch offices can be isolated or separated from conventional insurance services either operationally or geographically.

In evaluating the effectiveness of Sharī'ah governance functions of a window, "fit and proper" requirements applied to the BOD and senior management should be extended to the appointment of a Sharī'ah advisory function. However, this would depend on the jurisdiction's approach to Sharī'ah governance. Where the RSAs take or implement positions on substantive Sharī'ah issues, "fit and proper" requirements should include considerations of their suitability with respect to knowledge of the business, background and qualification of its members.

The differences in the operational and Sharī'ah characteristics of *takāful* products across countries highlight the need for international standardisation of the prudential framework. The IFSB and AAOIFI are central to bringing together *takāful* supervisory authorities, as they set the agenda for the regulatory development of the sector at the institutional level. It is strongly recommended that the cooperation the two standard-setting bodies are pursuing in terms of harmonising prudential standards and Shariah-based rulings for sound regulatory and supervisory practices of the three sectors that make up of Islamic finance should be sustained for further synergy and better harmony.

In those jurisdictions where *takāful* is still nascent, the supervisory authority should give more attention to additional training on important aspects such as Shariah-compliant investment and insurance for non-prohibited things, rather than a full legality audit for windows. Otherwise, insurance companies may hesitate to enter the market and establish a full-fledged company.

Takāful windows occur in different arrangements across jurisdictions. It is not acceptable for an insurer to sell products under a *takāful* arrangement or branding if the products are not truly *takāful* in nature. Therefore, the supervisor in a jurisdiction needs to be satisfied that appropriate policy measures are in place that guarantee the claims of Sharī'ah compliance of the products and services offered to consumers.

Proportionality allows the jurisdiction's supervisory framework to be applied in a manner appropriate to its legal structure, market conditions and consumers. The proportionality measure taken by the RSAs should at least be suitable, necessary and appropriate to attain the supervisory objectives of a jurisdiction. A proportionate application involves using a variety of supervisory techniques and practices that are tailored to the *takāful* entities to achieve their supervisory outcomes. Proportionality should take into account the nature, scale and complexity of *takāful* entities and the environment in which they operate.

Licensing of *takāful* windows raises a number of challenges regarding their supervision. As in most cases, supervisors overseeing *takāful* and *retakāful* windows within conventional (re)insurance institutions may be unfamiliar with the procedures and expertise required for supervision of this type of institution/activity. The supervisors therefore need to understand the potential issues and challenges that may arise in their supervision, including issues concerning the supervision of cross-border activities of a *takāful* or *retakāful* branch or a subsidiary of a foreign (re)insurance entity.

The IFSB and AAOIFI act as the benchmark for any supervisory regime aimed at developing the *takāful* sector. Regulators and *takāful* entities should familiarise themselves with the standards set by the IFSB and AAOIFI, and apply them to the maximum extent possible. The application of already tested accounting and auditing conventions could alleviate the burden on supervisors facing the new challenges imposed by *takāful* specificities. In addition, the digital transformation of the *takāful*/*retakāful* business model will allow the entity to improve margins to better serve its surrounding and future markets.

Finally, the IFSB is of the view that this paper addresses the relevant prudential regulatory and supervisory issues required for the orderly growth of *takāful* and *retakāful* windows, and the need to maintain an appropriate level playing field between the different *takaful* providers.

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