Regulating takaful

Lessons from Malaysia

Regulations play a significant role in determining whether takaful is simply a name change or develops into a different offering to the consumer. **Mr Zainal Abidin Mohd Kassim** of **Actuarial Partners Consulting** looks at Malaysia's approach to regulating takaful and the possible lessons for Indonesia and other markets.

Takaful, like insurance, is a service with a difference. In both industries, the consumer "pays" in advance for services to be rendered in the future. The service here is the payment of claims should it occur. This feature makes takaful a regulated industry.

Takaful is, however, different from conventional proprietary (a company with shareholders) insurance in one important aspect: the participants (policyholders) in takaful share insurable risks among themselves rather than transfer these risks to the shareholders. How takaful is implemented determines the level of this risk sharing among participants as, unless the takaful operation is based on a pure mutual model, shareholders do carry some of the risks of the operation.

This complexity in determining where risks actually reside makes the regulation of takaful a complicated affair.

This article looks at how Malaysia has regulated the industry since takaful was incepted with the establishment of Syarikat Takaful Malaysia (STM) in 1985, and what lessons Indonesia can learn from this experience.

Windows versus stand-alone takaful entities

Unlike Indonesia, Malaysian law never allowed the establishment of takaful windows. A separate Takaful Act was established in 1984 for takaful operations and separate regulations have since been issued specially for takaful companies. This could account for the small market share garnered by takaful in the initial years of its development. Indeed for the first eight years, STM was the only takaful operator in Malaysia.

The approach taken by Indonesia was to first allow windows. This has allowed insurers to quickly start up takaful windows and more importantly, allow the "sharing" of established distribution channels to sell takaful. The result was takaful becoming just another product offering of the conventional insurer and potentially public confusion as to the real difference between takaful and conventional insurance.

Takaful contracts

The Shariah-compliant *muamalat* contracts (the contract used defines the takaful model) that can be used for takaful in Malaysia was not set by regulations (unlike in countries such as Bahrain), but takaful models have to be approved by the regulators. This flexibility allowed for takaful contracts to evolve from the pure *mudharaba* model to the currently prevalent *wakala* model. Having a market with multiple models, however, raises several practical issues:

- Supervising takaful operators with different models is more difficult than having a standard model for all operators. This is because different models carry risks differently.
- Managing consumer expectations can be challenging in a multi-model environment.

Malaysia addresses the above issues by adopting a principle-based set of regulations. Such a regulatory regime, however, requires a market with sufficiently skilled human resources.

It is to be expected that a principle-based set of regulations would encourage innovation in the market place. Innovation, however, places another set of problems for regulators – how informed is the public when making choices? Are they able to differentiate between models in the market as to risk and return? Are intermediaries providing the appropriate advice so participants can make the correct choices? In Malaysia, strong transparency and disclosure guidelines were put in place to counter these concerns.

Legislating a standard takaful model has the advantage of making regulating takaful easier and standardising

Lessons from Malaysia

- Principles-based regulations requires a sufficiently skilled human capital
- Legislating a standard takaful model makes regulating takaful easier and standardises products available
- Treating Qard within takaful regulations allows operators to plan and price products accordingly
- Getting operators to move to less capital-intensive products means passing as much risks as possible back to participants

the products available so as to ease comparison by the consumer.

The Takaful Operating Framework (TOF)

Malaysia recently introduced the TOF to formalise the set of principles that takaful operators are required to follow. The framework is extensive with its prime purpose to ensure that participants will be treated fairly.

There are, however, certain aspects of the framework which resulted in controversy, not least how Qard hasan (an interest-free loan from the operator to the risk fund) is treated by the operator. The issue of Qard impairment raises the question of risk transfer to the operator, as opposed to risk sharing among the participants.

The treatment of Qard is fundamental to the question of whether takaful is the same or different from conventional insurance. In Malaysia, the decision by accountants to write off Qard after a period of time puts them at direct odds with the Shariah council, who feel that debt must always be paid off, irrespective of how long it takes.

Indonesia could consider embedding the treatment of Qard within the takaful regulations rather than leave this issue for the accounting fraternity to decide. This will allow takaful operators to plan and price their products accordingly.

The valuation of takaful contingent liabilities

For many years, how the actuary values family takaful contingent liabilities have been left to the discretion of the takaful operator's actuary.

The valuation of liabilities affects among others:

- The emergence of surplus within the participant's risk fund;
- The need for a Qard to finance valuation strains; and
- The basis of pricing takaful products and ultimately, how takaful products are structured.

The valuation regulations in Malaysia treat the contingent liability of family takaful products similar to non-participating conventional life insurance. This means that any surplus emerging from a valuation is considered incidental (ie, small).

This approach, however, can result in issues of equitability when different products are priced differently but are maintained in a single pool. Should negative liabilities be due to pricing having a built-in margin for future surplus distribution, this approach to valuation risks prematurely distributing surplus to the detriment of participants. Negative liabilities can also be due to the use of best estimate assumptions plus padding in pricing but valuing liabilities on a best estimate basis. Under current IFRS 4 accounting rules, there is a need to value liabilities with a margin for adverse deviation.

The regulator should consider how the valuation methodology required for takaful products can best ensure equitability of treatment among takaful participants, and at the same time provide for capital build up within the risk pool.

The advent of risk-based capital for takaful (RBCT)

The amount of capital required in a conventional insurance set up is predetermined primarily by two factors:

- How much capital is required to prefund expense overruns (where expenses exceed the sum total of expense provisions built into the pricing model); and
- The required risk capital to ensure a predetermined level of certainty that contingent benefit will be paid by the insurer.

In takaful, the main concern with RBCT is how the second factor would be met. At the outset, there will be little, if any, free surplus built up within the takaful fund. Building up free surplus would result in existing participants being deprived of surplus distribution.

The experience in Malaysia is for takaful operators to move to less capital-intensive products. This means passing as much risks as possible back to the participants. In a developing country, where there are a significant proportion of consumers who are not able to manage these risks, some thought should be given as to how risk can alternatively be managed within the takaful set up. Loading a takaful operation with capital only to manage risk is not a panacea to ensure the future solvency of the operation.

In Malaysia from a marketing point of view, products with guarantees are desired, including annuities. However, the existence of RBCT means such guarantees have to be underwritten by the operator (through additional RBCT capital). From the Shariah perspective, this would require different models (for example, the use of the wadiah contract); the regulator has not yet approved models with these structures.

Rules-based versus principles-based approaches

The decision of the regulator as to how takaful is regulated will have a significant impact on whether takaful is simply a name change (albeit Shariah-compliant) or develops into a different offering to the consumer. The lack of trained human capital sufficiently conversant in takaful (managers, distributors, actuaries, and so on) means that a principle-based regulatory approach may not be initially possible.

Given that the higher the solvency capital required for takaful, the greater the level of risk transfer and the less the level of risk sharing, the regulator should consider initially mandating the takaful model that can be used, the products available and the pricing level. It has to be remembered that in takaful, the product is priced by the operator but any losses are shared among the participants!

Mr Zainal Abidin Mohd Kassim is Principal & Actuary of Actuarial Partners Consulting and can be contacted at zainal.kassim@actuarialpartners.com.