Updates on Takaful: Regulating the way forward

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The spirit of takaful is about mutual assistance, individuals agreeing to help each other in the event of a loss arising from an unfortunate event. This is the essence of managing risks through a collective i.e. risk sharing. However, takaful in Malaysia has developed as a business with some elements of mutuality through the concept of surplus sharing among the participants and the takaful operator. Whether this "hybrid" interpretation of the original concept of takaful invalidates the original intention of takaful is debatable but, given this structure, it was a matter of time before BNM imposed regulations on conducting takaful business. We have seen this process accelerate in recent years.

In recent months, there has been a number of updated regulations and guidelines for the takaful industry in Malaysia. This includes:

- The introduction of the Islamic Financial Services Act ("IFSA")
- An updated Risk-Based Capital Framework for Takaful Operators ("RBCT")
- An updated Takaful Operational Framework ("TOF")
- A revised guideline on operating costs of Family Takaful business ("OCC guideline")
- A concept paper on the Appointed Actuary: Appointment and Duties ("AA Concept Paper")

This article summarises the key changes of the takaful regulations and guidelines highlighted above, and some of the potential implications of these changes to the takaful industry.

Introduction of IFSA

The introduction of the IFSA effective 30 June 2013 replaces the previous Takaful Act 1984. In addition, the IFSA combines both the regulations for Islamic Banking as well as Takaful, where previously there were separate Acts for the Islamic Banking sector and the Takaful industry.

One of the key changes under the IFSA is the requirement for composite takaful operators to split their general and family takaful businesses into two separate entities. Takaful operators are given five years from the effective date of the IFSA to comply with this requirement. This means that there will be separate capital requirements that need to be held by operators for its general and family takaful businesses. Previously, a minimum capital requirement of RM100 million is applicable for the combined general and family takaful business under the composite structure. It is anticipated that there will be several mergers and acquisitions as a result of this requirement, as an operator may find it too onerous to hold separate capital requirements and may decide to focus on either its family or general takaful business only. Nevertheless, the separation of family and general takaful businesses is also likely to encourage the growth of the general takaful industry in particular given the additional focus and specialization within the industry. Historically, in Malaysia, the growth of family takaful business has far exceeded the growth of the general takaful business as operators have tended to take advantage of the growth of the Islamic banking industry to develop its family takaful business, with limited attention being given to develop the general takaful business.

In addition, it is noted that the minimum capital requirement for takaful operators is no longer explicitly defined in the governing Act. Instead, the IFSA states that the minimum capital requirement will be specified by the Regulator. Previously, a minimum capital requirement of RM100 million was explicitly stated in the Takaful Act 1984. Although the actual impact of this subtle change is currently unknown, this principle-based approach in the IFSA may give some scope for the Regulator to determine the capital requirements depending on the nature and complexity of the business.

Under the IFSA, there is also a significant shift in responsibility from the Appointed Actuary to the Board of Directors of the takaful operator. A potential implication of the increased responsibility for the Board of Directors is a change in the composition of the Board, whereby takaful operators may increase the number of directors with professional qualifications relevant to the takaful industry to address the additional responsibility (e.g. those with technical experience such as accounting, actuarial, legal).

Another key change in the takaful regulations is the requirement for takaful operators to set up a Financial Holding Company. It is noted that the Financial Holding Company will also be subject to the requirements under IFSA.. However, there is a question whether a takaful operator subsidiary (of a Financial Holding Company) which is operating outside Malaysia (e.g. in an operating environment with a lower local capital requirement) will also be subject to the Malaysian capital requirements which may be more onerous and stringent compared to its local requirements. This will be disadvantageous to such takaful operator subsidiaries as having to hold a higher capital requirement compared to other players in the local market will result in uncompetitive pricing. Further clarification from the regulators on the treatment of capital in such a situation is essential if the intention is to venture overseas.

Updated RBCT

A recent update to the RBCT Framework applies a new restriction on the payment of dividends to the takaful operators. All dividend payments will henceforth be subject to prior approval from the regulators, regardless of its capital position. Previously, dividend payments were permitted without prior approval from the regulators subject to the capital position of the takaful operator being above its Internal Target Capital Level (“ITCL”). The requirement to check that the capital position remains above the ITCL remains but formal approval from the regulator will now also be required.

Updated TOF

In the latest TOF, takaful operators will be permitted to distribute surplus from the risk fund to the takaful operator (and therefore by implication to participants, see later), regardless of whether there is an outstanding *qard* position in the risk fund. In the previous TOF, takaful operators were not permitted to distribute surplus arising in the risk fund to operator’s fund prior to the full settlement of *qard* in the participants’ risk fund.

The Shariah Advisory Council of Bank Negara Malaysia, which is the highest Shariah authority in Islamic finance in Malaysia, resolved that surplus from the risk fund can be distributed despite an outstanding qard position in the risk fund due to the clear distinction between the obligation of the risk fund to distribute the surplus to the takaful operator and the obligation to repay qard, where the mechanisms of respective payments are subject to different requirements as issued by the regulators.

This represents a significant change in the surplus distribution policy, as takaful operators will now have more flexibility in withdrawing surplus from the risk fund despite an outstanding qard position, although the limitation on the total amount of surplus distribution payable to the operator not exceeding the amount paid or accrued to participants' remains. For example, as a result of this change in TOF, in a risk fund where the *qard* is caused by one particular product, surplus distribution to other profitable products in the same risk fund is now permitted. Under the previous TOF, all the surplus arising in the risk fund would have to be used to repay the outstanding qard first, thus resulting in a potential cross-subsidy between profitable and unprofitable products and/or those with a valuation strain .

Revised OCC guideline

The previous guideline on operating costs of the family takaful business was specifically applicable only to family takaful operators who were charging the operating costs directly to the takaful participants' risk funds. In comparison, the revised guidelines are now applicable to all family takaful operators, regardless of whether the operating costs are charged to the takaful participants' risk funds or otherwise. This means that all family takaful operators are now required to observe the limitations on agency compensation and management expenses as specified in the guidelines. Arguably, the guideline on limiting agency compensation and management expenses is only directly relevant for companies where these expenses are charged to the risk fund, as the guideline will prevent erosion of such funds due to excessive acquisition expenses and thus protect the policyholders' benefit expectations. This is because if expenses are not directly charged to the participants' risk fund and are fully borne by shareholders (i.e. financed through the predetermined wakala fees), it can be argued that it is not necessary to limit the level of expenses incurred as there is no impact on the policyholders' benefit expectations. Perhaps then representation should be made to BNM to clarify the situation where all expenses (including acquisition) are charged to the operator fund.

AA Concept Paper

Recently, the regulators issued a Concept Paper on the Appointment and Duties of Appointed Actuary for industry feedback. The AA concept paper was opened for consultation and feedback until early August.

Based on the AA concept paper, there is a potential requirement for the Appointed Actuary to be an employee of the takaful operator (e.g. rather than an external consultant) for both the family and general takaful businesses. In addition, the AA concept paper outlines the potential Pricing Actuary role, which is separate from the Appointed Actuary role.

The need for an in-house Appointed Actuary as well as a separate Pricing Actuary is likely to be a challenging requirement for takaful operators, given that there are a limited number of actuaries with sufficient takaful experience in Malaysia. This challenge is further compounded by the expected separation of the family and general takaful operations for the existing composite operators under IFSA within the next five years.

For example, currently one actuary may be sufficient to perform the Appointed Actuary role and the Pricing Actuary role for both family and general takaful business. In comparison, under the AA concept paper, there is a potential need for at least four actuaries to perform the Appointed Actuary and Pricing Actuary roles separately, for each of the family and general takaful businesses.

In addition, there is a significant increase in the responsibility of the Board of Directors in managing the takaful business, consistent with the requirements outlined under the IFSA.

Conclusion

Whist at the initial introduction of takaful in Malaysia BNM was content to allow the industry to “feel” its way through, nearly 30 years onwards this has now changed for good. It is clear that regulations now drive takaful. Prior to the introduction of Risk Based Capital for conventional insurers, there were very little regulations for takaful. In particular, there was no explicit solvency margin required for takaful and how surplus is shared between the contracting parties was left to the discretion of the operator. Pricing for takaful products therefore did not explicitly allow for regulatory capital.

As noted above, it very much looks like BNM is closing the regulatory gap between the conventional insurance companies and the takaful operators. Any arbitrage window available before where similar insurance and takaful products attracted different capital charges (and therefore different level of cost of capital) is fast disappearing. While this can be seen as a positive development from a solvency perspective, it comes with some drawbacks and we summarize particular issues below;

i) It was observed that, when RBC was introduced for life insurers in Malaysia, there was a rush to minimize the capital employed while maximizing return to the shareholders. We expect the same to happen for takaful (given it is run as a business) with the advent of RBCT. This means the withdrawal of capital intensive takaful products in exchange for capital friendly products such as investment-linked plans. These capital-friendly products transfer risks back to the participants. The question we should ponder now is whether the resulting expected limitation in product range in takaful limits the service that takaful can offer to the public.

ii) One of the aims of Islamic Finance is to expand financial inclusion, ensuring that those who avoid the non-halal conventional finance system is not left out on the benefits that a banking system brings to the public, for example in the provision of mortgages for the purchase of a home. Takaful completes the financial package by providing a means of managing mortality and morbidity risks - risks that affects the financial well-being of the individual through unexpected events. In the case of mortgages, this means providing for the payment of the outstanding loan if the borrower unexpectedly dies.

    Regulations on takaful ensure that takaful operators meet their obligations to the participants. This “certainty” comes with a cost as it requires funding by the takaful operator’s shareholders. However, there is a danger that in the drive towards “certainty” the cost of providing takaful becomes prohibitive. The additional cost due to this “tied” capital will be passed on to the consumers, thus making takaful products expensive. Competition does not work as well in insurance/takaful to drive prices down as what is provided is a service, not a tangible product. Consumers are not able to assess the “value” of a service, even more so when the “service” will only be provided in the future when a claim materialises. With additional capital and compliance costs, it becomes more likely that the higher level of financial inclusion to be expected from takaful will be constrained.

iii) There is also another level of financial inclusion which is providing cover to the lower income group, those who are most financially vulnerable to unexpected mortality and morbidity. This segment of the population is currently underserved by insurers and takaful operators as they do not present a good business opportunity, particularly given the over reliance on the agency force as a means of distribution in Malaysia. Policies in this segment of the market are usually small in premium size and distribution costs can be prohibitive. Regulatory compliance will further increase operating costs. A question that comes to mind is whether this segment of the market should be the the domain of a business or should be provided as a social service. Takaful in its purest sense as a mutual is perhaps the best model to service this segment of the market. However, the opportunity will be lost if the same set of regulations that govern takaful as a business applies to when takaful is used as a tool to achieve financial inclusion for the less well-off segment of the population.

The framework of takaful regulation and guidelines in Malaysia is one of the most robust and advanced in the world and Malaysia continues to be a leading example in the takaful industry globally. The latest regulations are yet another step in the drive to develop a level playing field between the conventional insurance and takaful industries. The question that can be asked is whether this move is premature as takaful has yet to develop to its fullest potential. There is a risk that because takaful has yet to fully develop, imposing more regulations will stifle innovation in the industry. The takaful industry is partly to blame for this lack of innovation which perhaps is due to the drive for profitability. Perhaps the time has come to pause and reflect on the journey for takaful so far and see whether there is still room to accommodate a takaful that is less of a business and more of a social service.

If you have any queries on the article above, please do not hesitate to contact the authors of this article or your usual Actuarial Partners consultants.

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