STRENGTHENING THE ROLE OF WAKEEL TO ENHANCE TAKAFUL VALUE CHAIN: CAPITAL ADEQUACY & SOLVENCY OF TAKAFUL FUNDS

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INTRODUCTION

- Takaful business creates a distinct category that does not easily fit into the existing classifications in the conventional insurance industry.
- Many people consider takaful as sort of a “hybrid” between a mutual and a commercial insurance business.
- Insurance regulation so far does not provide for such a hybrid form
- This poses some regulatory concerns and may require a different regulatory approach to address the unique characteristics of takaful operation.

REGULATING THE SOLVENCY OF TAKAFUL FUNDS

- Regulating and monitoring the solvency of insurance companies is an important aspect of insurance regulation
- A similar regulatory approach may be expected for Islamic insurance or takaful operations as well
- Solvency of takaful funds can be manifested by the ability of the funds to meet their obligations under all contracts at any time.
- Solvency indicators serve as critical early warning signal of the "financial health" of takaful funds and their ability to meet their liabilities
- Solvency requirement is a key regulatory tool in contemporary takaful regulation, especially in view of the increasing complexities of takaful business and operations.

THE CONTRACTUAL ROLE OF TAKAFUL OPERATOR

- In takaful operation, wakalah is the main and more prevalent contract between the operator and the participants
- The contract of wakalah allows the participants to authorise the takaful operator to be their wakeel (agent) to manage all the insurance aspects of the takaful operation, such as:
  - underwriting contributions
  - making actuarial evaluations to determine the pricing of the contributions
  - assessing the risk profiles and managing reserves
  - administering claims and their payments, etc.
- In addition, the wakalah may also be extended to authorise the operator to manage the investment aspects of the takaful fund as well.
- In consideration for the services rendered under the wakalah contract, whether in the insurance management or the investment management, the operator normally charges some fees.

CONTRACTUAL RESPONSIBILITIES OF TAKAFUL OPERATOR?

- Under the wakalah contract, the contractual responsibilities of the takaful operator are as a trustee (amin) and not as a guarantor (kafil).
- The takaful operator is not responsible in the case of any loss of deficit in the takaful funds in the course of the takaful operation, unless such losses or deficits are caused by negligence or fraud of the operator.
- In this sense, it can be said that solvency is not the direct responsibility of the takaful operator, but rather that of the takaful fund or ultimately the takaful participants.

WHAT ARE THE TAKAFUL PARTICIPANTS' REASONABLE EXPECTATIONS?

- Most participants expected takaful benefits as "guaranteed" similar with conventional insurance benefits.
- Most participants do not really understand the whole aspects of takaful operations, especially on the solvency issues, such as, responsibilities for covering deficits
- Most participants do not understand that the operator as wakeel is not responsible for deficits except in cases of negligence or fraud; or that the participants may have to contribute further to the fund in the case of deficit.
- Thus far, the Shari`ah rulings only allow imposition of further contribution on the participants upon deficit when it has been agreed upon by them in the original takaful contract.

ENHANCING THE ROLE OF WAKEEL IN MEETING SOLVENCY REQUIREMENTS

- The management of takaful underwriting lies with takaful operators
- The participants are normally unaware of the implication of solvency on their tabarru` funds – they expect the operator to be able to pay them when there is a claim.
- For the purpose of developing best practices in solvency regulation, a number of issues have to be addressed:
  - How to meet the participants’ expectations that their takaful benefits are “guaranteed”?
  - Are takaful operators ready to bear the responsibilities of solvency requirements in order to match the participants’ expectations?
  - Can the regulator impose solvency requirements on the takaful operators? Is it in line with the general spirit of takaful?

POLICY CONSIDERATIONS AND SAFEGUARDS IN SOLVENCY REGULATIONS OF TAKAFUL?

- Policy considerations may require additional safeguards to provide for more reliable solvency regime for takaful.
- Solvency regulation for takaful requires a deeper and policy-oriented thinking in order to match the specificities of takaful with the general mechanism of solvency regulation in the insurance industry.
- How?
  - Imposition of duty to give financial support on the operator?
  - Risk-Based Capital (RBC) regulatory framework for takaful?
  - Cross subsidies between takaful funds?

IMPOSITION OF DUTY TO GIVE FINANCIAL SUPPORT ON THE OPERATOR?

- The policy basis for imposing the responsibility for solvency on the operator reflects the current environment in takaful business, i.e.:
  - Takaful operators are licensed Islamic financial institutions in a regulated industry;
  - Takaful operators market their takaful products to the participants with the understanding that claims can be met from the takaful funds, and that they are expert in managing the funds;
  - Takaful operators make profits from their duty and expertise in the management of the takaful funds, and this should include solvency valuation and management;

IMPOSITION OF DUTY TO GIVE FINANCIAL SUPPORT ON THE OPERATOR?

- Putting some responsibilities on the takaful operators for the solvency of takaful funds emphasis on the need for wise management of the takaful funds in the performance of the operator's fiduciary duties and may prevent complacency and moral hazards; and
- Takaful participants have no say in the management of takaful. Thus, their level of understanding of the takaful operation, and their willingness to bear unlimited takaful liabilities are still questionable.

HOW DO OPERATORS GIVE FINANCIAL SUPPORT TO THE TAKAFUL FUNDS?

- Takaful operators use their shareholders’ funds to provide financial support to takaful funds through the practices of:
  - Qard (interest-free loan) to make good any deficit in the takaful funds;
  - Injection of assets into the takaful funds; and
  - Assignment or allocation of assets in the shareholders’ fund to cover any deficit in the takaful funds.
- What is the fiqhi position on the imposition of a duty on the takaful operator to financially support the solvency of takaful funds in the above manners?

RESOLUTIONS OF BNM'S SAC

- "In the event that the reserves are not sufficient to cover deficits in the Participants' Special Account (PSA), then the takaful operator must cover the deficits by giving financial help from the shareholders' fund by way of qard hasan." (38th Meeting)
- "SAC approved the Central Bank of Malaysia's proposal to impose on the takaful operators the responsibility for the solvency of takaful funds and to secure the benefits and savings of the participants through asset injection from the shareholders' funds into the takaful funds to cover any deficit that occurs based on the reason given. The security and injection of asset may be implemented by the takaful operator based on commitment to donate (iltizam bit tabarru`), i.e., the operator undertakes to give donation to cover all the claims (liabilities) on the takaful fund in the case of deficit." (46th Meeting)

RISK-BASED CAPITAL (RBC) REGULATORY FRAMEWORK

- RBC is a regulatory approach that requires the capital of a financial institution to correspond to the risks undertaken by them.
- Thus, a company that takes on higher risks will have to hold higher capital, compared to another company that is taking fewer risks.
- This regulatory approach will encourage the company to manage its risks within its financial available resources.
- Internationally, many regulators are moving towards introducing RBC requirement to their financial services industry
- Before RBC, capital regulation had been based on “minimum capital requirement” – applies equally to all financial institutions in the same industry, regardless of the level of risks undertaken by individual company

RISK-BASED CAPITAL (RBC) REGULATORY FRAMEWORK FOR TAKAFUL?

- Although RBC is not “water-tight” in preventing deficits and insolvencies, at least it is an improved regulatory attempt to minimize and manage such risks
- Should RBC be introduced to takaful industry as well?
- Internationally, most regulators use the minimum capital requirement for the takaful industry.
- This is a “one-size-fits-all” requirement and does not take into account the level of risks involved in individual company’s business activities
- Thus, it may be inadequate where companies take high risks positions that may affect the company’s ability to financially support the solvency of takaful funds

RISK-BASED CAPITAL (RBC) REGULATORY FRAMEWORK FOR TAKAFUL?

- RBC may be a prudent approach in regulating capital requirements for takaful companies as well.
- Although there is no guarantee by the takaful operators on the payment of claims because they are not the insurers, there are still responsibilities on the operators arising from their fiduciary position in the takaful operation (either as a wakeel, mudarib or amin / trustee).
- The regulation of capital requirement must consider the responsibilities and fiduciary duties of takaful operators in managing takaful operations and meeting their obligations to participants.

CROSS-SUBSIDY BETWEEN VARIOUS TAKAFUL FUNDS?

- Another mechanism to overcome the problem of deficits in takaful funds that is being considered by some takaful operators or perhaps the regulator is the practice of “cross-subsidy” between various takaful funds.
- In this mechanism, the surplus or available reserve of a type of takaful fund / scheme will be used to cover any deficit in another takaful fund / scheme under the management of the takaful operator.
- The idea is, to try to cover the deficit from the participants’ tabarru` funds first, regardless of the type of fund or its risk profile, before resorting to the injection of asset or fund from the operator by way of qard.

RESOLUTION BY BNM'S SAC

- The SAC disallowed the practice of using the surplus or reserves from one takaful fund to cross-subsidise the deficit in another takaful fund because:
  - The risk profiles and nature of liabilities in each fund are different. The participants in each fund may not have agreed to take different or higher risk profiles into their scheme
  - The original intent of the participants in the tabarru` contract is to be considered in determining whether cross-subsidy is intended to be covered by the fund or not
  - If there is no express provision for cross-subsidy in the terms of the tabarru`, then cross-subsidy is not allowed, because the participants are understood to intend to provide only for those with similar risk profile in their scheme only.

NO CROSS-SUBSIDY AT ALL?

- The need to cross-subsidise is especially felt by operators (particularly re-takaful operators) who are managing various takaful funds that have very small volumes individually such that it does not make commercial sense to manage them separately in term of surplus and deficit.
- If takaful operator or re-takaful company feels that there may be a need to cross-subsidise between different takaful funds, they should ensure that such a provision is included in the takaful / tabarru` contract wording, and agreed upon by the participants
- If the terms of tabarru` expressly provide that any surplus or available reserve of the fund can be used to cross-subsidise the other funds in the case of deficit, regardless of the nature of liabilities or risk profiles, then such a practice should be allowed

SOURCES OF FUNDS TO OVERCOME DEFICITS IN TAKAFUL FUNDS

- Reserves
- Re-takaful benefits (if any)
- Financial support from the operator on the basis of qard / hibah / iltizam bit tabarru`
- Further contributions from the participants:
  - either from their participants' accounts (if provided for in the takaful contract wordings); or
  - on the basis of qard (if provided for in the takaful contract wordings)

ENHANCED SOLVENCY FRAMEWORK FOR TAKAFUL?