

DRAFT FOR PUBLIC CONSULTATION
(22 June 2015—6 August 2015)



FINAL DRAFT

REVISED CONSULTATION DRAFT

**ISSUES IN REGULATION AND SUPERVISION OF
MICROTAKĀFUL (ISLAMIC MICROINSURANCE)**

**Comments on this Consultation Draft should be sent
to the IFSB (ifsb_sec@ifsb.org) and/or IAIS not later than 6 August 2015.**

22-2 JUNENOVEMBER 2015

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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 ~~involves, among others, includes~~ the issuance of exposure drafts ~~and the~~, holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as 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.

ABOUT THE INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS (IAIS)

The IAIS is a voluntary membership organisation of insurance supervisors and regulators from more than 200 jurisdictions in nearly 140 countries. The mission of the IAIS is to promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders and to contribute to global financial stability. Established in 1994, the IAIS is the international standard setting body responsible for developing principles, standards and other supporting material for the supervision of the insurance sector and assisting in their implementation. The IAIS also provides a forum for Members to share their experiences and understanding of insurance supervision and insurance markets. The IAIS coordinates its work with other international financial policymakers and associations of supervisors or regulators, and assists in shaping financial systems globally. In particular, the IAIS is a member of the Financial Stability Board (FSB) and the Standards Advisory Council of the International Accounting Standards Board (IASB) and a partner in the Access to Insurance Initiative (A2ii). In recognition of its collective expertise, the IAIS is routinely called upon by the G20 leaders and other international standard setting bodies for input on insurance issues as well as on issues related to the regulation and supervision of the global financial sector. For more information about the IAIS, please visit www.iaisweb.org.

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assists in shaping financial systems globally. In particular, the IAIS is a member of the Financial Stability Board (FSB), founding member and co-parent of the Joint Forum, along with the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO), member of the Standards Advisory Council of the International Accounting Standards Board (IASB), and partner in the Access to Insurance Initiative (A2ii). In recognition of its collective expertise, the IAIS also is routinely called upon by the G20 leaders and other international standard-setting bodies for input on insurance issues as well as on issues related to the regulation and supervision of the global financial sector. For more information about the IAIS, please visit www.iaisweb.org.

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EXECUTIVE SUMMARY/ABSTRACT

In their initiatives to enhance the regulatory best practices for financial inclusion, the Islamic Financial Services Board (IFSB) together with the International Association of Insurance Supervisors (IAIS) have jointly issued *Issues in Regulation and Supervision of Microtakaful (Islamic Microinsurance)*. The purpose of this Paper is to provide insights to the regulatory and supervisory authorities and industry players on the types of issues that arise from *Microtakaful* practices.

Both of these standard setters obtained data from the industry on the existing practices of *Microtakaful* providers by sending out survey questionnaires to relevant regulatory and supervisory authorities as well as *Microtakaful* providers. In addition, a literature review was done to enhance the paper by adding successful examples from various jurisdictions for the benefit of other jurisdictions.

This paper studies the various types of *Microtakaful* model, the supervisory framework and prevalent issues faced by *Microtakaful* providers and regulatory and supervisory authorities. In addition, for the benefit of jurisdictions that are new to *Microtakaful*, examples are given for practical illustration.

It is intended for the outcome of this Paper to provide guidance and understanding to regulatory and supervisory authorities on how effective supervision may be accomplished for the *Microtakaful* sector specifically. It serves to be the onset for further work to be done by both the IFSB and the IAIS in promoting the development of a prudent and transparent Islamic financial services industry. The future work may include introduction of standards and guidelines for *Microtakaful* that are consistent with *Shari'ah* principles, and recommending them for adoption.

Keywords: *Microtakaful*, Regulation, *Takaful*, Financial Inclusion

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ABBREVIATIONS

<u>AAOIFI</u>	<u>Accounting and Auditing Organization for Islamic Financial Institutions</u>
BOD	Board of directors
ECAI	External Credit Assessment Institution
FISC	Financial Inclusion Subcommittee
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principles
IFSB	Islamic Financial Services Board
ILO	International Labour Organization
JWG	Joint working group
MBA	Mutual <u>b</u> Benefit <u>a</u> Association
<u>MFI</u>	<u>Microfinance institutions</u>
MP	<i>Microtakāful</i> <u>p</u> Provider
MRF	<i>Microtakāful</i> Risk Fund
NGO	Non-government organisation
PRF	Participants' Risk Fund
RSA	Regulatory and <u>s</u> Supervisory <u>a</u> Authorities
RTO	<i>Re</i> <u>t</u> <i>Takāful</i> Operator
SB	<i>Sharī'ah</i> Board
SHF	Shareholders' Fund
TC	Technical Committee
TO	<i>Takāful</i> Operator
<u>TU</u>	<u><i>Takāful</i> undertaking</u>

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A. INTRODUCTION

I. Background to the Joint Work between IFSB and IAIS

1. The Islamic Financial Services Board (IFSB), in its inaugural Seminar on Regulation of *Takāful* held in Jordan on 10–11 January 2005, adopted several recommendations. One of these was that the IFSB should play “an active and complementary role to that of the International Association of Insurance Supervisors (IAIS) by issuing prudential and supervisory standards for *Takāful* that would safeguard the interests of the consumers and the soundness and the stability of the financial system as a whole” (IFSB & IAIS, 2006).

2. Pursuant to this recommendation, a joint working group (JWG) was established by the IFSB and IAIS in 2005 to produce an ~~issues p~~Paper on the applicability of the existing IAIS Core Principles (ICPs) on the *Takāful* sector and the regulatory and supervisory standards to be developed by the IFSB on *Takāful*. This JWG prepared a paper titled “Issues in Regulation and Supervision of *Takāful* (Islamic Insurance)”, which was issued in August 2006, providing background information on *Takāful* as well as an analysis of the applications of ICPs to the *Takāful* industry.

3. In this paper, four major themes were outlined to address the regulatory and supervisory issues within the *Takāful* industry:

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

4. Based on these themes, the IFSB has in subsequent years produced the following standards and guidelines:

- (a) IFSB-8: *Guiding Principles on Governance for Takāful (Islamic Insurance) Undertakings* [December 2009];
- (b) IFSB-11: *Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings* [December 2010];
- (c) GN-5: *Guidance Note on the Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on Takāful and Retakāful Undertakings* [March 2011]; and
- (d) IFSB-14: *Standard on Risk Management for Takāful (Islamic Insurance) Undertakings* [December 2013].

5. In July 2013, the IFSB participated in the IAIS Financial Inclusion Subcommittee (~~FISC~~) meeting held in Manila, Philippines.¹ A proposal was put forward during this meeting for a second joint initiative to be conducted between the IAIS and the IFSB, similar to the first issues paper initiative in 2006. Both organisations subsequently agreed to prepare a paper focusing on regulatory issues prevailing in the

¹ The IAIS has since 2006 worked on its “access agenda” by way of the IAIS-Microinsurance Network Joint Working Group and the Access to Insurance Initiative. Three papers on microinsurance have since been developed: (a) “Issues in Regulation and Supervision of Microinsurance” (June 2007); (b) “Issues Paper on the Regulation and Supervision of Mutuals, Cooperatives and other Community-based Organisations (MCCOs) in Increasing Access to Insurance Markets” (October 2010); and (c) “Application Paper on Regulation and Supervision Supporting Inclusive Insurance Markets” (October 2012).

Microtakāful sector and its role in enhancing financial inclusion. It was also agreed that a JWG – comprising members from both organisations – would work on this project.

6. Recognising the issues that the *Takāful* sector's regulatory and supervisory authorities (RSAs) face in relation to enhancing and strengthening the role of *Microtakāful* institutions, the Technical Committee (TC) of the IFSB, in its 32nd meeting held in Basel, Switzerland, recommended that the IFSB Council approve preparation of a ~~research~~ paper in this area. Consequently, the Council of the IFSB, in its 24th meeting held in Brunei in March 2014, approved the development of a research paper on *Microtakāful* as part of the IFSB's 2014 Workplan.

II. Objectives of the ~~this~~ Research Paper²

7. Taking into consideration the fact that there is currently a lack of studies on the operations of the *Microtakāful* sector and associated regulatory issues, the objectives of the joint initiative are:

- (a) to identify the current practices and models used for offering *Microtakāful* products, and the challenges and potential issues arising from *Microtakāful* transactions;
- (b) to review the current regulatory framework for the *Microtakāful* sector in various jurisdictions and suggest initiatives to strengthen the framework and thus enhance financial inclusion through the *Takāful* sector; and
- (c) to provide guidance to the RSAs on establishing an enabling environment for the overall development and growth of the *Microtakāful* sector.

B. ABOUT MICROTAKĀFUL

8. Research conducted in 2010 suggests that in ~~countries populated by Muslims~~ Muslim populated countries, such as Indonesia (207 million), Pakistan (160 million), India (151 million) and Bangladesh (132 million), which have been classified by the World Bank as lower-middle and low-income countries, insurance penetration is low due to the contradictions between insurance principles and *Sharī'ah* principles (Erlbeck, 2010).

9. *Microtakāful* is widely known in the industry as *Takāful* for low-income populations. In general *Takāful* terms, "low-income" means that section of the population that is customarily not eligible and not invited to participate in any of the *Takāful* plans of any *Takāful* Operator (TO). This group's ineligibility is attributed to members' inability to meet the basic financial and underwriting requirements set forth by *Takāful* regulation, for reasons relating to medical history, hazardous occupation, irregular income, insurable interest, and various other considerations that fall within the purview of prudential regulation of exclusive finance. An important cause is the unavailability of suitable insurance products that fit the needs of this specific group of customers in combination with their lack of awareness and understanding of the usefulness of insurance to manage the risks in their private and professional lives. Another contributing factor is the lack of expertise and will of TOs to make the investment that is needed to reach these markets.

10. With the financial industry's focus shifting towards inclusive finance, major initiatives have been undertaken worldwide to include this low-income population in the financial system, to ensure that they are as privileged as the high-income population. The industry sees the need for this low-income group to be

² In the nomenclature of the IFSB this paper is to be considered a Research Paper and in that of the IAIS an Issues Paper.

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enabled to participate in the various products and plans offered by banks and insurance/*Takāful* companies, as well as any other facilities offered by these financial institutions. The condition of this segment of society makes it more vulnerable to financial losses; therefore, there is a great need for it to have some sort of financial protection. Microinsurance/*Microtakāful* is therefore an important tool to protect it from financial losses, and to help it break the cycle of poverty.

11. From the perspective of the *Takāful* industry, more TOs have started shifting their focus to include the low-income segment ~~via *Microtakāful* products in line with the financial inclusion agenda of their respective governments. For example, in 2014, under the Malaysian Government's Bantuan Rakyat 1 Malaysia ("BR1M") or 1-Malaysia Public Relief~~ programme, an initiative to help low-income earners to reduce their financial burden has ~~done exactly that been launched.~~³ The initiative has brought all of the TOs operating in Malaysia together to provide an i-BR1M scheme for people earning ~~a monthly household income below US\$1119 and USD839 monthly household income and below~~ (Takaful Ikhlas, 2014).⁴

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12. Various definitions of *Microtakāful* have been applied to categorise this group of low-income participants. For example, jurisdictions may categorise these participants based on their minimum annual income, product features, the location of potential participants, or their distribution channels.

13. While in certain jurisdiction *Microtakāful* products are focused on low-income earners, in some other jurisdictions they are targeted specifically at low-income Muslims. One research paper defined *Microtakāful* as "a concept developed for deprived people in Muslim countries" (Gor, 2013). In Africa, *Microtakāful* is defined by *Takāful* Insurance of Africa as "a mechanism to provide *Shari'ah*-based protection to the blue-collared, under-privileged individuals at an affordable cost" (Takaful Insurance of Africa, 2012). While other definitions of *Microtakāful* are cited in numerous academic papers, the objective nevertheless remains the same: to include in the financial system certain sections of the population who, under normal circumstances, would be excluded.

14. For the purpose of this paper, *Microtakāful* shall be defined to be consistent with the definition of *Takāful* as provided in IFSB-8, ~~(IFSB, 2009a) (IFSB, 2009)~~, taking into account the core principles embedded in the concept of mutual assistance:

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Microtakāful is the Islamic counterpart of microinsurance,³ and exists in both Family and General forms. It is a joint-guarantee initiative, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks, under the core principles of Tabarru' (donation), Ta'āwun (mutual assistance) and Prohibition of Ribā (usury). Microtakāful is

³ According to the IAIS, microinsurance does not include government social welfare, as this is not funded by premiums relating to the risk, and benefits are not paid out of a pool of funds that is managed based on insurance and risk principles (IAIS, 2012). However, the aforementioned scheme may not fall under this category of government social welfare, as it involves the normal underwriting process although the contribution is paid by the Government of Malaysia. Furthermore, "The Landscape of Microinsurance in Asia and Oceania 2013", a briefing note published by Munich Re Foundation, describes this form of scheme as social microinsurance, whereby its premiums are fully or largely subsidised by the government and underwritten by insurers.

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⁴ i-BR1M is a one (1)-year *Takaful* plan that provided protection to recipients in BR1M categories of households/families. i-BR1M aims to ease the burden of the recipient and/or recipient's families in the event of his or her death (accidental and non-accidental) or accidental total permanent disability. The i-BR1M contribution is borne entirely by the Government of Malaysia. Furthermore, i-BR1M is managed by a *Takaful* Operator consortium.

⁵ The IAIS has defined "microinsurance" as insurance that is accessed by low-income populations, provided by a variety of different entities, but run in accordance with generally accepted insurance practices (which include the ICPs) (IAIS, 2012). The IAIS also uses the term "inclusive insurance" for all insurance products that are aimed at the excluded or underserved insurance market. In practice, the term "microinsurance" is often used interchangeably. Where the term is used in this paper, it is considered to mean inclusive insurance.

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generally offered to [the] low-income and under-privileged segment of the population (which is usually excluded from the general *Takāful* terms and conditions) by various entities which are regulated and supervised by regulatory and supervisory authorities of *Takāful*/insurance or any other competent regulatory and supervisory authority under the national laws of any jurisdiction.

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15. Given the evolving nature of *Microtakāful*, the definition shall be subject to periodic review for appropriateness as the *Microtakāful* industry grows and matures.

16. While the distinction between *Microtakāful* and *Takāful* is made based on the inclusivity and exclusivity of the financial system, it is worth reiterating that, conceptually, *Microtakāful* does not differ from *Takāful*. It is a subset of *Takāful*. It exists under the premise that microinsurance⁶ does not meet the basic principles of *Sharī'ah*, where elements of *Riba* (usury), *Maysir* (gambling) and *Gharar* (uncertainty) are prohibited.⁷ However, due to the exclusivity nature of *Takāful* products, the specific regulation of *Microtakāful* has not been given much attention by the regulatory and supervisory authorities despite the new development of promoting inclusive finance in the financial industry. This might be due to the mere fact that little experience or empirical data is available for prudential regulation to take place effectively without dampening the growth for inclusiveness.

17. Sections B.I–B.III of this paper aim to provide basic background information on (i) the types of *Microtakāful* models that are currently being used in the industry, (ii) key differentiating elements between *Takāful* and *Microtakāful*, and (iii) the differences between *Microtakāful* and microinsurance. Section B.IV will highlight the findings of the survey conducted by both the IFSB and the IAIS for the purpose of this paper.

18. Section C then draws upon the various *Microtakāful* (and, in some scenarios, microinsurance) issues and challenges that have also been observed in the *Takāful*/insurance industry from a regulatory perspective. This section divides the issues on regulation of *Microtakāful* into four segments: (i) corporate governance; (ii) financial and prudential regulation; (iii) transparency, reporting and market conduct; and (iv) the supervisory review process. In addition, where appropriate, examples of practical situations faced by some RSAs that have initiated regulations on *Microtakāful*/microinsurance will be provided to give insights into various approaches that have proven to be either successful or unsuccessful in regulating *Microtakāful*.

I. Models/Types of *Microtakāful*

19. In following the due process of ~~research paper~~ development of this paper, the JWG undertook a survey⁸ to attain an understanding of the various models used to develop *Microtakāful* products. While two models – *Wakālah* and cooperative – were popular with the survey respondents, this paper provides various

⁶ The IAIS published "Issues in Regulation and Supervision of Microinsurance" in June 2007, entailing definition of microinsurance and the issues and challenges in regulating the sector.

⁷ IFSB-8: *Guiding Principles on Governance for Takāful (Islamic Insurance) Undertakings* states that the concept of *Takāful* is significantly defined by *Tabarru'* commitment, *Ta'awun* and prohibition of *Riba* (usury).

⁸ Two sets of survey questionnaires (set A for market players and set B for supervisory authorities) were sent to the IFSB's and the IAIS' member countries to be completed between 10 July and 15 August 2014. A total of 25 institutions responded, with ten indicating their non-participation due to the absence of *Microtakāful* in their jurisdiction. The remaining 15 participating respondents were made up of six regulatory authorities and nine *Microtakāful* providers. The low participation rate was believed to be due to the fact that *Microtakāful* is still not popular in many jurisdictions of the IFSB's and IAIS' member countries, as compared to its conventional counterpart, microinsurance.

other *Microtakāful* models that are known to be used in certain jurisdictions that did not respond to the survey⁹.

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(a) **Wakālah Model**

20. Under a *Wakālah* model, the *Microtakāful* Provider (MP) and the participants form a principal-agent relationship whereby the MP acts strictly as a *Wakīl* (agent) on behalf of the participants, to manage the risks as well as the investment of the contributions. In return for the service rendered by the MP as *Wakīl*, the MP receives a management fee, called a *Wakālah* fee, which is usually a percentage of the contributions paid. The *Wakālah* fee must be pre-agreed and be expressly stated in the *Microtakāful* contract. For the MP, the *Wakālah* fee is intended to cover the total sum of: (i) management expenses, and (ii) a margin of operational profit to the MP. In this respect, an MP will be profitable if the *Wakālah* fee it receives is greater than the management expenses incurred. It does not directly share in the risk borne by the *Microtakāful* Risk Fund (MRF) or any of its investment profit or surplus/deficit.

21. In addition, the *Wakālah* model may permit the MP to receive part of its remuneration as *Wakīl* in the form of a performance-related fee. A performance-related fee, as agreed in the *Microtakāful* contract, is typically related to the underwriting result of the MRF. The underwriting result arising in the MRF, after payment of the *Wakālah* fee, including any performance-related element, and after crediting any investment income, is attributable to the participants collectively.

(b) **Wakālah–Muḍārabah Model**

22. In a *Wakālah–Muḍārabah* model, as commonly practised, the MP acts both as a *Wakīl* and a *Muḍārib* (entrepreneur) to the participants: typically, as *Wakīl* to manage the underwriting activities of the MRF, and as *Muḍārib* to manage its investment activities, though the exact relationship and basis of remuneration in respect of these activities will be specified in the *Microtakāful* contract. The MP receives a *Wakālah* fee, which is usually a percentage of the contributions paid, as described above, and may (where the contract permits it) receive a performance fee based on the underwriting result. In addition, the MP is remunerated by a predetermined percentage share in the investment profit.

23. Some RSAs permit extension of the *Muḍārabah* element of the model to cover also the underwriting results of *Microtakāful* operations.¹⁰

24. As with the *Wakālah* model, the residue in the MRF after payment of all contractual obligations, including profit shares due to the MP, is attributable to the participants collectively.

⁹ The mutual models have been used for microinsurance products in Philippines. Usually, the mutual model is a not-for-profit model applied by the microinsurer. In this model, the microinsurer's shareholders who are also participants establish a mutual MRF fund. Participants in a mutual model automatically become owners of the Mutual MRF fund at the inception of participation. Participants jointly contribute to the mutual fund, which is used to service the claims of member participants. Similarly to the cooperative model, all management expenses and acquisition costs are paid out of the mutual MRF fund. Participants comprise the general assembly of the microinsurer, which is responsible for appointing the board of directors. Also, participants may either receive a share of the surplus or a reduction in future contributions if the surplus is retained.

¹⁰ Many scholars disagree with the MP taking any percentage of an underwriting surplus under a *Muḍārabah* contract, on the ground that an underwriting surplus is not a profit, though some consider that a performance fee may be permitted. In any event, none of the respondents to our survey claimed to be using a pure *Muḍārabah* model.

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(c) **Wakālah–Waqf Model**

25. Under a *Wakālah–Waqf* model, the MP's shareholders and potentially also *Microtakāful* participants contribute seed money to the establishment of the *Waqf* MRF. In addition to acting as a *Waqif* (trustee) to the *Waqf* MRF, the MP also undertakes the role of a *Wakil* to manage the underwriting activities. The *Wakālah* fee must be pre-agreed and be expressly stated in the *Microtakāful* contract.

26. The residue in the MRF after payment of all contractual obligations, including profit shares due to the MRF, is attributable to the *Waqf* fund.

(d) **Cooperative Model**

27. In a cooperative model, the MP's shareholders and the participants establish a *cCooperative* MRF ~~out of which~~. All management expenses and acquisition costs are paid ~~out of the Cooperative MRF~~. There is, however, a difference between the Saudi ~~and Sudan cCooperative mModel and the Sudan Cooperative Model~~. In the former ~~Saudi Model~~, the MP applies the *Wakālah* contract to its *Takāful* scheme, hence entitling itself to a *Wakālah* fee. It also takes a share of the underwriting surplus from the Cooperative MRF. In contrast, the Sudan *cCooperative mModel* does not allow the sharing of any surplus between the MP and the participants; instead, all the surplus belongs to the participants. Furthermore, the Sudan ~~Cooperative MmModel~~ applies the *Muḍārabah* contract to its *Takāful* operation; hence, it ~~would be~~ is remunerated via a predetermined share of investment income for being a *Muḍārib*. Another important feature of this model is that the participants have their own representatives appointed by them on the board of directors (BOD).

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(e) **Mutual Model**

28. ~~Usually, the mutual model is a not for profit model applied by the MP. In this model, the MP's shareholders who are also participants establish a Mutual MRF. Participants in a mutual model automatically become owners of the Mutual MRF at the inception of participation. Participants jointly contribute to the MRF, which is used to service the claims of member participants. Similarly to the cooperative model, all management expenses and acquisition costs are paid out of the Mutual MRF. Participants comprise the general assembly of the MP, which is responsible for appointing the BOD. Also, participants may either receive a share of the surplus or a reduction in future contributions if the surplus is retained.~~

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(f) **Sharing of Surplus**

29. ~~Surplus sharing is an element of *Takāful* that is still being deliberated upon at length by the *Takāful* industry. Well known for its unique payback feature, many industry players still use this mechanism for sharing any surplus with participants as an enticement feature to attract the general public to participate in *Takāful* plans. This is especially obvious in General *Takāful* products, which are renewable annually. It is usually at the end of the certificate term that any surplus generated from the Participants' Risk Fund (PRF) will be shared between the participants and the shareholders of the TOs. As envisaged in IFSB-8, any surplus generated from the PRFs will usually be shared according to a pre-agreed percentage between the shareholders and the participants. The portion allocated to participants will either be distributed to the participants themselves or be retained in the PRF to build up the reserves to strengthen the fund for solvency purposes (IFSB, 2009).~~

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30. Although the issue with regards to surplus sharing remains the responsibility of the *Shari'ah* Board (SB) of each jurisdiction and is likely also to remain an issue for MPs, it is not this feature that is creating concern among MPs and their stakeholders. The real predicament is whether the surplus should be distributed to the participants or be required to remain in the MRF. In a sector where the obligation to honour claims is much higher than the imperative to make a profit out of product offerings, the need to ensure sufficiency of the MRF places a greater burden on the MPs. This makes it even more crucial for solvency of the MRF to be observed. To achieve this, some MPs argue that the most appropriate mechanism is to retain any surplus in the MRF. The objective of surplus retention must be disclosed to participants to ensure that transparency is observed, especially in practices where participants are not represented in the corporate governance of the MPs.

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31. However, whether this approach is feasible or practical remains an open question that needs to be answered by MPs and their RSAs. There needs to be proper judgment on whether it is more viable to retain a surplus in the MRF (to build the capital strength of the fund) or to distribute it to the *Microtakāful* participants (in an attempt to increase their interest in products that have a payback feature). An alternative practised in certain jurisdictions is to direct the surplus to the general welfare of the low-income group or to enhance the benefits of the product. This practice provides the low-income group with a general sense that they are gaining something back through the enhanced benefits and better welfare. Another suggestion is that it may be more appropriate for any surplus to be ploughed back as *Tabarru'* for additional personal accident cover, since the amount of surplus generated from the small contribution of *Microtakāful* participants does not normally count as a form of savings for this low-income population. They would benefit more if extended coverage were provided (Mokhtar, Sulaiman, & Ismail, 2012).

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32. An example of surplus being distributed is the declaration of a surplus by *Takāful* Insurance of Africa (TIA) in Kenya, whereby all its policyholders, including the *Microtakāful* participants, received a total of USD120,000 for the financial year ending December 2012 (Chao-Blasto, 2014). TIA believes that "surplus distribution is the beauty of *Takāful* and a testimony to *Shari'ah* compliance, fairness and equity of the process" (Takaful Insurance of Africa, 2013).

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II. Differences between *Takāful* and *Microtakāful*

~~33-28. Given that~~ The conceptual similarities between *Takāful* and *Microtakāful* ~~as are~~ explained in paragraphs 14 - 16, ~~the following shall~~ illustrates the differences between them, prior to discussing the need to change the current regulatory framework of the *Takāful* industry in order to regulate *Microtakāful*.

(a) Types of *Microtakāful* Providers

34-29. *Takāful* exists in a highly regulated financial environment, whereby the *Takāful* Operators ~~TOS~~ are required to be licensed prior to being allowed to offer *Takāful* products to the industry. Among the key requirements to be fulfilled are the need ~~to~~: (i) ~~to~~ be *Shari'ah* compliant in their operational model, (ii) ~~to~~ meet minimum capital requirements, (iii) ~~to~~ have in place a governance framework that addresses the interests of all key stakeholders, (iv) ~~to~~ have in place a *Shari'ah* governance framework for ascertaining *Shari'ah* compliance at all times, and (v) ~~to~~ have in place an investment and risk management framework

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for prudential management of the funds overseen and managed by the TOs – that is, the Shareholders' Fund (SHF) and the Participants' Risk Fund (PRF).¹¹ The current regulations on these TOs are pertinent, since they are profit-oriented and competition is stiff between the various TOs. RSAs are responsible for prudential and/or market conduct supervision to protect the interests of the *Takāful* participants and might consider that the profits generated by the TOs are not achieved at the expense of the *Takāful* participants.

35. — *Microtakāful*, on the other hand, exists in an environment that is not as yet strictly regulated in many jurisdictions. With the worldwide financial system opening its doors to financial inclusion, RSAs in various jurisdictions remain elusive when it comes to regulating the MPs. This elusive approach has led to the existence of MPs that may or may not be licensed by the *Takāful*/insurance RSAs to offer *Microtakāful* products to participants. Hence, some of these MPs may not fulfil the regulatory and supervisory requirements of normal TOs. Three types of MPs have been identified to provide *Microtakāful* products to the participants. ~~("MPs" shall henceforth refer to institutions offering *Microtakāful* products, including licensed TOs.)~~

30. —
(i) The first type of MP is the TOs themselves. These are formal institutions that are regulated by the RSAs of *Takāful*/insurance in their own jurisdictions. Governed by *Takāful* regulations, these licensed TOs create products that are specifically targeted at the low-income population. Although some of these products may or may not follow the same guidelines as normal *Takāful* products, they nevertheless go through a thorough product development process required by the RSAs using a proportional approach.¹² Although some TOs do not specifically term their products as "products for low-income earners" or *Microtakāful* products, several TOs have started this initiative when plans with annual contributions of just USD3 started to be offered to rural populations.¹³ Many TOs in the industry have since taken up the challenge to provide *Microtakāful* products to the low-income population by modifying their underwriting requirements through the creation of simple and easily comprehensible products. These products are developed with the conscious mindset to uphold the *Maqasid*¹⁴ of *Sharī'ah* within the population (Vejzagic & Smolo, 2015).

Example: Since 2001, Prime Islami Life Insurance Ltd in Bangladesh has launched several products (its Monthly Small-Savings Assurance Plan, Prime Islami Deposit Pension Scheme and Kalyan-Bima Two Payments Deposit Pension Scheme) aimed at the poorest members of society since 2001. These products were created for agricultural and factory workers, small traders and housewives, as well as for self-employed workers. Such people are not able to make a large annual contribution but are able to contribute US\$2 monthly ~~(ICMIF Takaful, 2014c)(ICMIF Takaful, 2014).~~

¹¹ IFSB-8: *Guiding Principles on Governance for Takaful (Islamic Insurance) Undertakings* recommends six guiding principles as a reference for the establishment of a TO's governance framework. IFSB-11: *Standard on Solvency Requirements for Takaful (Islamic Insurance)* provides seven key features to be followed in constructing a solvency structure for TOs. IFSB-14: *Standard on Risk Management for Takaful (Islamic Insurance) Undertakings* provides key elements for constructing a risk management framework for TOs.

¹² The IAIS' "Application Paper on Regulation and Supervision Supporting Inclusive Insurance Markets" (October 2012) provides guidance on proportionate approaches to be used for inclusive finance. The proportionality principle works two ways: (1) for low-risk activities, simpler and less burdensome guidelines are used; and (2) for complex and riskier activities, more sophisticated methods and techniques will be used.

¹³ Syarikat Takaful Malaysia has, since its incorporation in 1984, offered inexpensive funeral expenses group plans to the poor. This initiative is followed by Etiqa Takaful Bhd, also in Malaysia when the organisation started in 1993. These products are also made available to the rural population. Since 1998, Amana Takaful of Sri Lanka has been providing coverage to cottage industries and the self-employed in that country, with a focus on people running small businesses.

¹⁴ *Maqasid of Sharī'ah* means the objectives of *Sharī'ah*. Under Islamic jurisprudence, the five main objectives of *Sharī'ah* to protect the interests of mankind are: (i) protection of *Al-Din* (religion), (ii) protection of *Al-Nafs* (life), (iii) protection of *Nasl* (lineage and family), (iv) protection of *Al-'Aql* (intellect or mind), and (v) protection of *Al-Mal* (property).

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(ii) The second type of MP consists of the institutions regulated by formal entities other than RSAs of *Takāful*/insurance, under laws other than *the Takāful*/insurance law in their jurisdictions. These are formal institutions that may or may not exist to generate profits. Their main source of income is not insurance/*Takāful* activities. They may or may not be licensed, but nevertheless they are regulated. Such organisations range from *Zakah* and *Sadaqah* collectors, to many other types of charity-driven institutions or associations whose main reason for being is to provide for low-income earners and the poor. These MPs may also be government agencies that work together with TOs to come up with *Microtakāful* products; or they may be microfinance institutions (MFIs) that provide loans to the low-income population, and whose *Microtakāful* products are just side products that are bundled together to cover the loans provided by these MFIs.¹⁵ Products offered by these formal entities are usually driven by state or national initiatives to promote financial inclusion. Contributions from this second type of MP may come from the participants themselves, from *Zakah* or *Sadaqah* funds, from donations, or even from the national budget, to provide *Microtakāful* protection for the low-income segment of the population. The regulations that govern their activities may not be as stringent as the regulations imposed by the RSAs of TOs.

Example: An example of a government-driven initiative is the *Microtakāful* scheme launched together with the Farmers Welfare Federation of Malaysia (a non-government organisation, or NGO). The product, developed by *Takāful* Ikhlas in 2007, was funded by the Malaysian government with contributions of as low as US\$6 per annum. It provides an immediate death benefit of US\$140 and covers 100,000 members (Mokhtar, Sulaiman, & Ismail, 2012).

(iii) The third type of MP is unregistered and unregulated institutions. These are informal entities that are unregulated by RSAs of *Takāful*/insurance law, or any other formal entities under laws other than *Takāful*/insurance laws. These MPs may be informal groups or community associations that are created to provide *Microtakāful* coverage to their own members. Some of these guaranteed benefits include funeral expenses benefits, or simple death or total permanent disablement benefits. The participants in these MPs are not protected under any type of legal settings.

Example: In Malaysia, especially in rural areas, members of the community often establish a funeral expenses fund where annual contributions of as little as US\$1.40 are collected from members of the village. Such groups are unregistered and based on good faith, with the collectors being appointed by the village's mosque.

(b) Types of Participants

~~36-31.~~ *Takāful* participants are regular income earners. More often than not, they are average and above-average income earners. Although different jurisdictions may define "basic infrastructure" differently from one another, most of the *Takāful* participants live in areas with basic infrastructure including roads, markets, water and electricity. Their socioeconomic conditions allow them to have easy access to common financial products offered by the *Takāful* industry. *Takāful* participants are also more exposed to various financial products offered by financial institutions, hence making information asymmetry less of an issue for them. They are also very much aware of the importance of *Takāful* products through the various campaigns carried out by the TOs in these areas, which are easily accessible by intermediaries of TOs.

~~37-32.~~ *Microtakāful* participants are, on the other hand, ~~irregular~~ underprivileged or low-income earners. Many *Microtakāful* participants do not enjoy basic amenities. They have less exposure to financial products simply because of the lack of campaigns carried out by financial institutions in the areas where they live,

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¹⁵ In Sri Lanka, this practice is widespread due to the absence of the licensing requirement on MPs.

due to the lack of basic infrastructure. Under the general financial terms, they may not have access to financial services due to their socio-economic condition, which may include residing in areas that are unreachable by the most common means of communication and transportation due to the lack of development. In general *Takāful* terms, *Microtakāful* participants are commonly the group of people who do not fulfil the financial and underwriting requirements, due to their inability to meet the basic health and financial requirements-criteria as stipulated by the TOs' underwriting and financial requirements. It has been observed that the profiles of *Microtakāful* clientele would mostly coincide with those of microfinance participants. This, however, may extend to include people who do not necessarily need a loan but are low-income and have insurable risks.

39-33. Example: Amana *Takāful* Insurance¹⁶ works together with Muslim Aid Sri Lanka to implement Islamic microinsurance in Sri Lanka through its scheme, Micro Insurance Navodaya. ("Navodaya" means "dawn of a new era".) Among the targeted groups are garment manufacturing companies, in order to promote *Microtakāful* to factory workers who fall within the low-income bracket and are able to pay only USD0.22 a month. Amana *Takāful* Insurance also targets workers on tea estates.

(c) Product Features and Contributions

39-34. Takāful products generally come with various kinds of product features, ranging from simple to complicated. Simple product features are products that require minimum explanation and minimum prerequisite knowledge on the part of the participants prior to participating in the plan. Two examples of simple product features are death and total permanent disablement benefits, whereby the MP does not require extensive and comprehensive explanation to enable the participant to understand the product. The terms and conditions for participation are also easy to comprehend since the exclusions are minimal. Complicated product features, on the other hand, require certain prerequisite knowledge on the part of the participants and thorough explanation on the part of the MP. A good example is hospital and surgical plans. The participants need to be able to comprehend the types of hospitalisation and surgical procedures that are covered under the plan, as well as the limit that they are able to claim under the plan. This requires time and effort on the part of the MP, with appropriate follow-up clarification for better understanding by the participants, especially in understanding the terms, conditions and exclusions that come with such product features. Sophisticated products are made available for *Takāful* participants since they are generally easily reachable by *Takāful* intermediaries through common means of communication and transportation. With these variations in product features, the contribution amount required of these products will reflect its simplicity or sophistication, which does not pose economic constraints on those who can afford these products.

40-35. Microtakāful products, on the other hand, are in practice generally simpler and easier to understand as compared to Takāful products. Their simplicity is pertinent in reaching out to participants residing in areas that may not be easily accessible by normal means of communication and transportation by the MPs. Simplicity is also a key consideration in product design, given the economic capability of participants to obtain such coverage for an affordable contribution. It is also worth mentioning that simple product features translate to simple claims procedures and verification, which is a key operational requirement of a successful *Microtakāful* initiative. Furthermore, simplicity promotes a positive experience among the participants new to Microtakāful schemes, which results in growth of the Microtakāful industry.

41-36. Example: A credit *Microtakāful* plan was introduced by Takmin (*Takāful* Mikro Indonesia) in 2006 as a joint partnership between *Takāful* Indonesia and Peramu, an NGO. The plan covers participants for

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¹⁶ <https://www.takaful.lk/>

the outstanding balance of their financing. In the event of death or total permanent disablement, the outstanding financing balance will be settled by *Takāful Indonesia*. Takmin works together with cooperative bodies that act like MFIs on the island of Java to provide loans to start-up businesses or to help expand a current business. These MFIs provide Grameen-style microfinance for women from poor families, with 25–30 women providing mutual help to each other and the financing provided based on *Qard* (Mokhtar, Sulaiman, & Ismail, 2012).

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(d) **Distribution Channels**

42-37. *Takāful* products are known to have complex and costly distribution channels. Given the range of products, from simple to very sophisticated, TOs need a range of channels that are able to meet the requirements of different categories of participants. The most common ones are individual agents, corporate agents, *bancatakāful* and brokers. These distribution channels survive based on the various layers of the agency and brokerage commission structure. The pricing of *Takāful* products is hence dependent on the type of distribution channel used to distribute the products to the participants. The more complex the product channel, the higher the transaction costs will be, as manifested in the contribution paid by the normal participants who expect better services to be provided by these intermediaries.

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43-38. *Microtakāful* products, on the other hand, are simple, yet though challenging, to distribute due to the demographic characteristics socio-economic of the participants in certain jurisdictions. The need to remain simple, yet affordable, makes distribution taxing, since the majority of the participants as the participants may reside in areas that are unreachable by normal means of communication and transportation. Low-cost distribution is essential to a successful *Microtakāful* development. Some of the popular distribution channels that have been identified in the industry include the use of mobile phones. The transactions (exchange of *Aqd* and payment of contribution) take place via the deduction of mobile phone credit and by an exchange of a contract that sets out in simple fashion the terms and conditions of the *Microtakāful* products. Some MPs have indicated that they appoint small grocery stores or pawnshops as distribution channels, since they are frequently visited by *Microtakāful* participants. There are also instances where distribution channels are provided by government, or by associations providing social welfare initiatives that are tied up together with the MP's products. Such simple distribution channels, with few agency layers to share commissions, help to drive down the transaction costs for distribution of *Microtakāful* products. It is also the case that trust plays an important role in the use of certain types of distribution channel. Where products are distributed via local mosques, religious groups or trade unions, the participation rate seems to be higher. An example of how this works is the appointment of the mosque as the agent of the MP, in which the mosque collects the monthly contribution from the local Muslim community. The contribution will then be transferred to the MP. In the event of death or total permanent disablement, the MP will provide claims payment to the beneficiary of the deceased through the mosque. Another channel that is slowly being adopted by *Microtakāful* participants is MFIs. Through product bundling, *Microtakāful* products are automatically attached to the products of the MFIs and distributed by that means.

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44-39. **Example:** Takmin (*Takāful* Micro Indonesia) works together with an NGO, Peramu, to empower the poor in Indonesia through *Microtakāful* products. Peramu works closely with Baytul Maal Wat Tamawil Cooperative to distribute *Microtakāful* products in Bogor, Indonesia (Haryadi, 2006).

(e) **Consumer Education**

45-40. *Takāful* objectives and values are widely understood by middle-income earners, who lead Muslim consumers in terms of their purchasing power. The high-significant level of awareness among middle-

income earners can be attributed to the development of Islamic finance, as well as to governments' direct involvement in supporting the conducive atmosphere and enabling environment for growth of the *Takāful* industry. This is especially true for countries such as Malaysia, Pakistan and Nigeria, where the RSAs have issued various guidelines and frameworks particularly for *Takāful* market players.

46-41. *Microtakāful* objectives and values ~~are not known or~~ may not be well understood by the target market itself. This is due to the low level of education and financial literacy of that market, which makes it incognisant of the risks that may cause it further suffering and financial losses. More often than not, potential *Microtakāful* participants see no value in paying a contribution for future benefits that may or may not be paid to them. This phenomenon has led to weak demand for *Microtakāful* products. Lack of awareness and understanding of *Microtakāful* has also opened doors to deliberate mis-selling of *Microtakāful* products by irresponsible agents, which has further damaged the reputation of *Microtakāful*. Some studies have suggested that awareness programmes could be conducted by mosques, *Musallas* and *Zakah* institutions, as they are within reach of the aforementioned target market.

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47-42. **Example:** The collaboration between Amana *Takaful* and Muslim Aid has contributed immensely to the development of *Microtakāful* and *Takāful* understanding among the low-income segment in Sri Lanka. Muslim Aid specialises in providing *Sharī'ah*-compliant microfinance services to the financially underprivileged, making it the best platform for dissemination of such information. Dissemination of information is done through regular meetings and awareness programmes that coincide with dates of payment of microfinancing, which has given the aforementioned institutions an opportunity to interact directly with low-income earners. This initiative has boosted the demand for *Microtakāful* in Sri Lanka (Lanka Business News, 2010).

(f) **Operations**

48-43. *Takāful* Operators' operations are usually lengthy, due to their complex structure. In certain countries, potential participants would have to go through agents in order ~~for them~~ to participate in a *Takāful* scheme. Usually it would take a few days for the applications to be processed and approved by the TOs. Claims management also goes through the same lengthy process. Although TOs are required to ensure that claims management is conducted amicably, they have a set of processes and procedures that they must follow in order for them to pay the claims made by participants or their beneficiaries. This lengthy process is designed to prevent fraudulent claims or payment of invalid claims that may affect the TOs' funds.

49-44. *Microtakāful* Operators' operations are less complicated than those of TOs. The process of subscribing to *Microtakāful* schemes has been made simple, putting such schemes within reach of potential *Microtakāful* participants. Furthermore, just like the TOs, MPs are required to ensure that claims are processed and paid promptly and without unnecessary delays. However, the claims management process still has a proper mechanism in place for controlling fraud. In practice, some MPs transfer their processing and approval of applications and the claims process to their ~~non-governmental organisation~~ NGO or government agency partners.

50-45. **Example:** In Malaysia, Etiqa *Takaful* and Angkatan Koperasi Kebangsaan Malaysia (a government agency) launched the *Tabarru'* Koperasi scheme, which covers death and total permanent disability for members aged up to 80 years. The scheme is open only to members of the cooperative, and to members of cooperatives that are overseen by Angkatan Koperasi Kebangsaan Malaysia (Angkatan). The

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contribution for this scheme ranges from just US\$1.30 to US\$6.80 per year, and pays a death benefit of up to US\$5159. The operation of this particular scheme has been simplified, in the sense that participating cooperatives manage applications and claims for their members. (ICMIF, 2014b) (ICMIF, 2014).

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III. Differences between *Microtakāful* and Microinsurance

~~51-46.~~ The differences between *Microtakāful* and microinsurance are the same as the differences between *Takāful* and insurance. The absence of *Shari'ah* non-compliant elements namely *Riba*, *Maysir* and *Gharar* in *Takāful* as explained in IFSB-8 is also reflected in the product features and contractual relationship between the MPs and its participants. This makes *Microtakāful* products more appealing to those sections of the population that are conscious of the religious implications of their participation in the financial services offered by various types of financial institutions. In Pakistan, for example, ~~96% of the majority of the population is Muslim. Muslims believe that the~~ While the principles of mutual cooperation is "acceptable", in this country many believe that the principles set forth in the conventional insurance mechanism are against their faith and beliefs. ~~On the contrary other hand,~~ they accept that the principles in *Microtakāful* promote cooperation among members of the community and serve the people better (Khan, 2013).

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~~52-47.~~ The core principles of *Takāful*, as outlined in paragraph 14 of IFSB-8, are equally applicable to *Microtakāful*.¹⁷

IV. Survey Findings on Industry and Regulatory Practices of *Microtakāful*

~~53-48.~~ In an effort to understand the *Microtakāful* sector better, the IFSB and the IAIS undertook a survey on *Microtakāful* in the third quarter of 2014. This section provides an analysis of the survey responses, bearing in mind that the number of responses received may not be sufficient to form any concrete conclusions as to the nature of the *Microtakāful* industry. However, the analysis served as guidance in developing the remainder of this paper.

~~54-49.~~ When the survey was sent out, it was intended to target institutions providing *Microtakāful* products. While the survey was sent to 64 institutions/RSAs, only 25 respondents provided feedback. Contributing to the low response was the non-offering of *Microtakāful* products, with 10 of the 25 respondents stating "non-offerings" as their main reason for not participating in the survey.

~~55-50.~~ Based on the limited information provided by 15 participating respondents, the survey results indicated that, while *Microtakāful* is still not as widespread as normal *Takāful* products, a few institutions have already taken steps to provide coverage to the low-income population via low-contribution and simple products – most commonly, death, total permanent disablement and credit *Takāful*. Although the infrastructure for *Microtakāful* administration is not fully in place for many of these 15 institutions, steps have been taken to ensure that products and claims administration procedures have been simplified to provide ease of transactions for participants.

¹⁷ The three core principles cited in IFSB-8 are *Tabarru'* commitment, *Ta'awun* and the prohibition of *Riba*. (1) *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. (2) Under the concept of *Ta'awun*, or mutual assistance, participants agree to compensate each other mutually for the losses arising from specified risks. As *Takāful* has often been perceived as a form of cooperative or mutual insurance, the initial objective is not to gain profit but to assist one another mutually, under the principle of *Ta'awun*. (3) Conventional insurance business involves the element of *Riba*. Hence, it is important that investments in both the *Takāful* funds and the shareholders' funds are *Riba*-free types of investment.

~~56-51.~~ From a regulatory perspective, the survey results indicate that there is currently no specific regulation on *Microtakāful* in place. Where the MPs are non-TOs, there may not be a specific regulation to oversee their operational framework. Where MPs are TOs, they may be required to adhere to the existing regulations and guidelines that relate to normal TOs. These include the requirements for licensing and for appointing intermediaries, solvency requirements, and the separation of the MRF and SHF.

~~57-52.~~ To preserve the interests of participants, MPs are required to have a similar governance framework, the key organs of which are the ~~board of directors~~BOD, *Shari'ah* Board (SB) and senior management. Three RSAs indicated that, where conflict arises, the same rectification mechanism that is already in place for normal TOs will be used for MPs.

~~58-53.~~ While the findings provide certain insights into what is currently going on in the industry, the amount of information acquired through the survey exercise may not be indicative of what the majority of MPs are currently doing or not doing. Nevertheless, the survey could provide a means to highlight all the potential areas requiring the attention of the regulators of MPs.

~~59-54.~~ To quote a paragraph from the IAIS paper *Issues in Regulation and Supervision of Microinsurance* (June 2007), "Regulators and supervisors in emerging market jurisdictions have little experience or empirical data to support their role in creating an 'inclusive' insurance market that works effectively for the upper as well as the lower income segments, with the latter being the focus of microinsurance. This lack of data exemplifies the fact that the RSAs of MPs may be encountering similar challenge in regulating the *Microtakāful* sector"¹⁸ (International Association of Insurance Supervisors, 2007).

~~60-55.~~ The following section aims to highlight the issues and challenges of *Microtakāful* in the areas of (i) corporate governance;¹⁸ (ii) financial and prudential regulation;¹⁸ (iii) transparency, reporting and market conduct;¹⁸ and (iv) the supervisory review process. Appropriate examples may be cited from relevant sources to provide a better understanding of the issues, challenges and opportunities that are engulfing the *Microtakāful* sector.

C. SUPERVISORY AND REGULATORY FRAMEWORK FOR *MICROTAKĀFUL*

~~61-56.~~ The previous section provided background on *Microtakāful* and outlined how it differs from *Takāful*. This section looks at the issues and challenges arising from prudential regulation of *Microtakāful* practices in the industry. Relevant examples of the specific issues faced in various jurisdictions are highlighted in this section to illustrate how they may be handled effectively. Specific reference is also made to some of the work that has been done by the IAIS on microinsurance, specifically on the proportionate application of ICPs to the regulation of microinsurance. The relevance of these ICPs to *Microtakāful* is highlighted.

I. Corporate Governance

~~62-57.~~ The corporate governance structure of an MP is as important as the corporate governance structure of any financial institution. MPs are responsible for upholding not only their economic obligations to the participants, but also the principles of *Shari'ah*. Issues pertaining to the governance structure of MPs are thus highlighted in this section.

¹⁸ When the IAIS conducted its survey of members in 2006, only 35 institutions provided feedback.

63-58. Similar to *Takāful*, various stakeholders play key roles in sustaining the *Microtakāful* sector. These stakeholders include the *Microtakāful* participants, government agencies, RSAs, the Shari'ah Board^{SB}, and especially the MPs, which may be formal or informal entities.

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(a) **Interests, Roles and Responsibilities of External Microtakāful Stakeholders**

(i) **Government**

64-59. The welfare of low-income members of society is highly dependent on the social security services of the state government of each particular jurisdiction. In many jurisdictions, social security provides subsistence to individuals with inadequate or no income. In developed nations such as the United States and the United Kingdom, the social security system is well planned and covers all qualified citizens. In other parts of the world, coverage may not extend to all low-income earners. For example, in Indonesia, which has a population of over 220 million, only 17% of the working population is covered under the contributory social insurance (International Labour Organization, 2015). The rest of the population in the informal economy relies on local mutual support arrangements. In Pakistan, there are two types of social security programmes; one provides benefits to needy Pakistani Muslim citizens, the other to needy Pakistani citizens (U.S Social Security Administration Office of Policy, 2006). Similar to Indonesia, Pakistan's social security programme covers employed citizens only. Family labour and self-employed persons are excluded from these schemes.

65-60. There have been efforts to expand the scope of coverage in these mentioned countries through various outreach programmes such as that conducted by the International Labour Organization (ILO) in Indonesia. Various initiatives have been taken to expand the scope of coverage for social security. The ILO, for example, formulated the National Employment Guarantee Programme for Indonesia to help alleviate situations of poverty, unemployment and underemployment, particularly among youth and in rural areas, as well as to create productive assets and services for the economy (National Planning Agency & International Organisation, 2005).

66-61. This outreach programme is an example of how state governments of various jurisdictions may include populations in rural areas that are not easily accessible by normal means of transport, where access to basic amenities is limited, and where low-income earners are generally excluded from participating in even the simplest forms of financial services. Under such a programme, governments would use taxes and contributions collected from the higher-income segment of the population to provide for the basic needs of the low-income segment.

67-62. While it is still uncommon for many government agencies to provide *Microtakāful* coverage to the lower-income segment, for the simple reason that few *Microtakāful* products are being offered by the majority of formal MPs, there may be a need for these agencies to create awareness among low-income earners, educating them on the need to have basic coverage to protect their loved ones in the event of their demise. In addition, these government agencies may need to work together with formal MPs to design simple protection schemes that are not detrimental to the financial condition of the formal MPs but at the same time help to widen the scope of financial services so that they include the low-income population. Another viable option would be for the government to work together with established grassroots organisations. Such collaboration helps to build these organisations' capacity to deliver *Microtakāful* products to their members.

68-63. Comprehending the roles and functions of RSAs and regulators of other formal entities in regulating the *Takāful* industry is crucial, especially when the stability and soundness of the industry is key to the sustainability of MPs. This will ensure that the products offered to the low-income segment will be successful and not detrimental to the survival of any of the key stakeholders.

69-64. Lack of cooperation between government and MPs might lead to conflict. An example would be when the contribution provided by the government is insufficient to cater for the solvency requirements of the MPs, especially if these MPs are TOs that need to fulfil the regulatory solvency requirement under their *Takāful*/insurance law. Since claims are paid from the risk funds of the MPs, insufficient contributions may lead to a high claims ratio of the MPs. This, in turn, may affect other participants of the MPs, especially if the MPs lump the contribution of *Microtakāful* products together with the contribution of normal *Takāful* products.

(ii) Regulatory and Supervisory Authorities

70-65. Regulatory and supervisory authorities of MPs that are TOs play a key role in understanding the nature of *Microtakāful* participants prior to regulating the *Microtakāful* industry, since literacy, financial stability and accessibility may be constraints on participation by the low-income population. This thorough understanding will facilitate the role of RSAs in helping to expand the scope of *Takāful* coverage to the low-income population via *Microtakāful* products. Some of the areas in which RSAs may play a supporting role include:

- (a) introducing proportionate regulatory and supervisory requirements (which cover corporate governance, financial and prudential regulation, market conduct, and the supervisory review process) for both low- and high-risk *Microtakāful* participants;
- (b) providing an avenue for all stakeholders of *Microtakāful* to interact and understand their differing roles and functions. These stakeholders include government agencies, charitable organisations, MPs, the central *Shari'ah* advisory board, intermediaries and potential participants;
- (c) providing accessible channels of communication/recourse for *Microtakāful* participants in cases of misrepresentation/fraud;
- (d) ensuring that products developed by MPs actually address the needs of the low-income segment;
- (e) ensuring that the MPs entering the market are there for the long term, and not for short-term gains, to demonstrate the value of *Takāful*;
- (f) understanding the demographic nature of *Microtakāful* participants through the development of separate mortality and morbidity tables which capture all the insured and uninsured population, understanding the risks that revolve around them which may be uncommon among the insured population, understanding the nature of occupation of these participants, and assessing whether the barriers to their participation are real or arise from misperceptions of financial products;
- (g) outlining a different mechanism for monitoring intermediaries, which may include non-conventional intermediaries such as pawn shops, small grocery stores, mobile-phone service providers, etc.;
- (h) ensuring close monitoring of the financial condition of formal MPs to ensure that the offerings of *Microtakāful* products are not made at the expense of the stability and soundness of the MPs, and that any risks taken by TOs to include the high-risk, low-income population will not affect the *Takāful* industry in the long run;
- (i) identifying the various types of MPs that offer *Microtakāful* plans in their jurisdictions which may or may not be regulated by these RSAs, for the purpose of understanding the risks that these MPs might pose to financial stability; and

- (j) understanding the regulations of other jurisdictions that have been established for microinsurance/*Microtakāful*, prior to coming up with its own regulations to suit the local requirements and adaptability.¹⁹

71-66. In jurisdictions where *Microtakāful* initiatives are government-funded programmes, the question arises as to whether these RSAs should be held responsible for programmes that they cannot prudentially supervise effectively. This is a delicate area, especially if the programme is subsidised by the government or funded by charity. The MPs themselves might not be able to fully enforce the imposing of underwriting requirements on participants. The possibility will then arise of RSAs being in conflict with the government. To ensure the success of government-funded *Microtakāful* programmes, cooperation between the government and RSAs plays a key role. The RSA would act as a facilitator of the scheme, a moderator in the event of conflicts, and a protector in upholding participants' rights.

(iii) *Retakāful* Operators

72-67. Licensed MPs that are regulated by RSAs have access to services provided by *Retakāful* Operators (RTOs). In circumstances where RTOs are required to provide coverage for *Microtakāful* products of MPs, a comprehensive understanding of the nature of *Microtakāful* participants is crucial to ensure that these RTOs are aware of the types of risks involved where *Microtakāful* participants are concerned.

73-68. Just like the TOs, the licensed MPs are exposed to the risk of insolvency of the MRF due to high claims, poor underwriting and insufficient contributions. MPs that are involved in government-funded *Microtakāful* initiatives whereby the contributions are subsidised by the government are at particular risk. Since it is the MP's fiduciary duty to ensure that claims are paid, it is essential that *Retakāful* arrangements are in place in initiatives such as these. RTOs must have the capacity to underwrite risks that are relatively new to them.

74-69. Difficult circumstances may arise when an MP is not licensed under any jurisdiction's *Takāful* or insurance law. MPs may not have access to *Retakāful*/reinsurance services, hence limiting their ability to expand the scope of coverage.

(iv) Regulated MPs (by regulators of formal entities other than RSAs)

75-70. Entities that are not regulated by the RSAs, but which may be regulated by other regulators of formal entities such as the *Zakah*, *Waqf* and other types of charitable entities, may sometimes be involved in *Microtakāful* initiatives. When this happens, the products sold may ~~not be required to~~ go through the same stringent product development process they would have undergone had an RSA been required to

¹⁹ The Republic of South Africa in 2011 issued its "South African Microinsurance Regulatory Framework" to facilitate a more conducive financial environment for financial inclusion. The framework, which was developed by the National Treasury, had the following aims: (a) to extend access to a variety of good-value formal insurance products appropriate to the needs of low-income households, thereby supporting financial inclusion; (b) to facilitate formalised insurance provision by currently informal providers, and in the process promote the formation of regulated and well-capitalised insurance providers and small business development; (c) to lower barriers to entry, which should encourage broader participation in the market and promote competition among providers, further supporting poverty alleviation through economic growth and job creation; (d) to enhance consumer protection within this market segment through appropriate prudential and business conduct regulation, improved enforcement of regulatory transgressions, and consumer education interventions targeted at understanding insurance and its associated risks and benefits; and (e) to facilitate effective supervision and enforcement, supporting the integrity of the insurance market as a whole.

provide approval. This may pose a challenge to the various stakeholders of the *Microtakāful* schemes, especially the *Microtakāful* participants. No specific requirements for clients' protection might be imposed; hence, participants are more susceptible to ~~mis-selling and other mis-selling, misconduct by~~ *Microtakāful* intermediaries, ~~and damaging poverty alleviation efforts.~~

The regulator of formal entities responsible for supervising non-*Takāful*-related entities has an essential role in ensuring that entities attempting to replicate *Takāful* products for the benefit of the low-income population do not do so at the expense of the participants themselves. These regulatory agencies may wish to consider defining the requirements in their respective laws prior to allowing non-*Takāful* entities to offer *Microtakāful* products.

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(b) Interests, Roles and Responsibilities of Internal Microtakāful Stakeholders

(i) Takāful Operators

~~76-71.~~ In expanding the product offerings to include the low-income population, the TOs may need to take a comprehensive approach so as to better understand the new segment of the target market. It is crucial for these TOs to consider the interests of all stakeholders and identify the gaps that may arise when high-risk, low-income groups are offered *Takāful* products.

- *Shareholders*: The shareholders of *Microtakāful* operators need to be assured that the *Microtakāful* products offered to the high-risk segment will not jeopardise the profitability of the TO. ~~This may be done through profitability test of Microtakāful products, through comprehensive stress test and various other tests that may assure the shareholders of the sanctity of operation.~~ Furthermore, the shareholders have to be in this market for the right reasons, taking a long-term, capital investment approach and being willing to substitute some of the expected financial returns with social objectives. Additionally, proportionate pricing for *Microtakāful* products needs to take into consideration the need for the MPs to stay solvent and stable, while at the same time remaining competitive in the market. The TOs need to fully understand the types of risks they are exposed to when offering products to the low-income segment of the population ~~so that the shareholders will not suffer from poor returns on their investments.~~

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- *Sharī'ah Board*: The TOs need to ensure that the *Microtakāful* product offerings meet the requirements set out by the SB. In addition, the intermediaries used to distribute the products, and the mechanisms by which the products are sold, should meet ~~at least~~ the basic *Sharī'ah* requirements ~~set forth for TOs~~ whereby transparency and disclosure of information is key to transferring rightful information to the relevant parties. The SB may also play a role in ensuring that the *Microtakāful* products are truly inclusive and reach the ~~most~~ vulnerable members of society as propagated under the principles of *Takāful*.

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- *RSAs*: The TOs need to ensure that the basic requirements pertaining to the product development process, fulfilment of regulatory requirements and monitoring of the financial condition of the institution as required by the RSAs are followed strictly. Any cooperation done with entities non-regulated by RSAs of TOs (e.g. Sri Lanka deregulated its insurance sector to allow for new providers such as the MFIs to provide *Microtakāful* products) should be monitored and not compromise the stability of the *Takāful* industry.

- *Government and charitable agencies*: Any kind of cooperation or partnership that is conducted between the TOs and the government or charitable agencies should be clearly spelled out and be notified to the RSAs that are in charge of supervising these TOs.

- Distribution Channels: The TOs need to ensure that ~~its~~their distribution channels observe and explain properly to the participants and potential participants the *Microtakāful* principles and never misled them into expecting that *Microtakāful* is no different from conventional microinsurance. Since these channels are key to ascertaining that the products reach ~~its~~their target market, TOs need to also to ensure that proper remuneration is in place.

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(ii) Board of Directors

As custodians of public funds, MPs are governed by active and dedicated BODs that have been entrusted by their respective shareholders with protecting the interests of *Microtakāful* stakeholders. IFSB-8 emphasises the establishment of a governance framework by the BOD, with the BOD overseeing its implementation. RSAs may want to apply the proportionality approach to the directorship requirements discussed below.

The IFSB-8 also suggested that the BOD establish an additional committee, namely the governance committee, to focus primarily on protecting the interests of the *Microtakāful* participants (IFSB, 2009).

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72. Another important role of the BOD is to approve all policies and procedures of MPs relating to *Shari'ah* matters. The BOD should be able to resort to appointing a *Shari'ah* advisory firm to oversee the *Shari'ah* aspects of the business (IFSB, 2009). Such approval would only be granted to the management upon consultation with the *Shari'ah* Supervisory Board. Furthermore, the BOD maintains its oversight of the performance of the senior management of the MPs in managing their affairs and business activities. The BOD also has the authority to reduce surplus distribution, or to retain surplus in the MRF if it believes building up reserves is more beneficial (Archer, Karim, & Nienhaus, 2009). Such decisions made by the BOD may need to be conveyed to the *Microtakāful* participants through proper channels to get them to be more engaged and better understand the value of *Takāful*.

73. Prior to their appointment, members of the BOD are required to go through "fit and proper" assessments. Such assessments are conducted at least annually to ensure that the members remain fit and proper to oversee the MPs' operations at all times. The "fit and proper" criteria encompass the following (Laws of Malaysia, 2013):

- probity, personal integrity and reputation;
- competence and capability; and
- financial integrity.

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74. The BOD is expected to establish various committees which include, but are not limited to, the audit committee, nominating committee, remuneration committee, risk management committee. This same expectation is also recorded in Central Bank of Malaysia's *Guidelines on Directorship for Takaful Operators*. Furthermore, IFSB-8 suggested that the BOD establish an additional committee, namely the governance committee, to focus primarily on protecting the interests of the *Microtakāful* participants (IFSB, 2009a).

75. Another important role of the BOD is to approve all policies and procedures of MPs relating to *Shari'ah* matters. The BOD should be able to appoint a *Shari'ah* advisory firm to oversee the *Shari'ah* aspects of the business (IFSB, 2009a). Such approval would only be granted to the management upon consultation with the SB. Furthermore, the BOD maintains its oversight of the performance of the senior

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management of the MPs in managing their affairs and business activities. The BOD also has the authority to reduce surplus distribution, or to retain surplus in the MRF if it believes building up reserves is more beneficial (Archer, Karim, & Nienhaus, 2009). Such decisions made by the BOD may need to be conveyed to the *Microtakāful* participants through proper channels to get them to be more engaged and better understand the value of *Takāful*.

77. A good example for this is the issuance of guidelines and standards by the Central Bank of Malaysia pertaining to corporate governance of MPs. Although these guidelines and standards are applicable to MPs, they may face some difficulty in applying those same requirements of directorship to their corporate governance structure, especially if they are unregulated. RSAs may want to apply the proportionality approach to the directorship requirements discussed below.

As custodians of public funds, MPs are governed by active and dedicated BODs that have been entrusted by their respective shareholders with protecting the interests of *Microtakāful* stakeholders. IFSB-8 emphasises the establishment of a governance framework by the BOD, with the BOD overseeing its implementation. Under the aforementioned governance framework, the BOD is expected to establish various committees which include, but are not limited to, the audit committee, nominating committee, remuneration committee, risk management committee, and a *Shari'ah* Supervisory Board which is in tandem with the provisions stipulated by the Central Bank of Malaysia in its *Guidelines on Directorship for Takaful Operators*²⁰ (IFSB, 2009) (BNM, 2004).

78. The BOD is able to resort to appointing a *Shari'ah* advisory firm to oversee the *Shari'ah* aspects of the business (IFSB, 2009). In addition to the establishment of the aforementioned committees, IFSB-8 suggested that the BOD establish an additional committee, namely the governance committee, to focus primarily on protecting the interests of the *Microtakāful* participants (IFSB, 2009).

79-76. The *Shari'ah Governance Framework*²¹ states that the BOD of MPs is responsible for establishing a sound and robust *Shari'ah* governance framework. Such a framework specifies the following (BNM, 2010):

- the BOD's oversight of the *Shari'ah* compliance aspects of MPs' operations;
- establishment of a *Shari'ah* board;
- establishment of *Shari'ah* governance functions which include *Shari'ah* research and secretariat, *Shari'ah* risk management, *Shari'ah* review and *Shari'ah* audit;
- establishment of internal *Shari'ah* risk management, review and audit processes; and
- issuance and dissemination of *Shari'ah* resolutions to relevant stakeholders.

80-77. The *Islamic Financial Services Act* 2013 emphasises that the responsibility for overseeing the implementation of *Shari'ah* governance does not lie only with the *Shari'ah Supervisory Board*^{SB}, but also

²⁰ The *Guidelines on Directorship for Takaful Operators* are applicable to all *Takāful* operators, inclusive of *Microtakāful* operators.

²¹ The *Shari'ah Governance Framework* is applicable to all Islamic financial institutions governed by the Central Bank of Malaysia, inclusive of *Microtakāful* Operators.

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with the BOD. It further explicitly requires the BOD to have due regard to any decision of the SBSharf'ah Supervisory Board pertaining to any *Sharf'ah* issue in respect of the execution of the business, affairs or activities of MPs. "The board of directors shall have due regard to any decision of the *Sharf'ah* committee on any *Sharf'ah* issue relating to the carrying on of business, affairs or activities of the institution." Additionally, a specific legal provision catering to the *Takāful* business states that, in the event there is a conflict between the interests of the participants and the shareholders, the BOD must give priority to the interests of the participants. "The board of directors of a licensed *Takāful* operator shall, in the event of conflict between the interest of the *Takāful* participants and the shareholders, give priority to the interest of the *Takāful* participants."

~~81. Another important role of the BOD is to approve all policies and procedures of MPs relating to Sharf'ah matters. Such approval would only be granted to the management upon consultation with the Sharf'ah Supervisory Board. Furthermore, the BOD maintains its oversight of the performance of the senior management of the MPs in managing their affairs and business activities. The BOD also has the authority to reduce surplus distribution, or to retain surplus in the MRF if it believes building up reserves is more beneficial (Archer, Karim, & Nienhaus, 2009). Such decisions made by the BOD may need to be conveyed to the Microtakāful participants through proper channels to get them to be more engaged and better understand the value of Takāful.~~

~~82. Prior to their appointment, members of the BOD are required to go through "fit and proper" assessments. Such assessments are conducted at least annually to ensure that the members remain fit and proper to oversee the MPs' operations at all times. The "fit and proper" criteria encompass the following (Laws of Malaysia, 2013):~~

- ~~• probity, personal integrity and reputation;~~
- ~~• competence and capability; and~~
- ~~• financial integrity.~~

~~83-78.~~ Also, the *Guidelines on Directorship for Takāful Operators* issued by the Central Bank of Malaysia state that the appointment of BOD members does not threaten the interests of participants, *Microtakāful* claimants, customers or creditors of MPs. The guidelines stress that the members of the BOD should not behave in a manner that may cast doubt on their fitness to hold their respective positions in the BOD which may lead to decisions and actions that are detrimental to the interest of MPs and their participants (BNM, 2004).

~~79.~~ The composition of the BOD is pertinent to ensure that a sufficient number of members is always present to give proper direction and guidance to the management of the MPs. The Central Bank of Malaysia has stipulated that this number should be no less than five ~~(5)~~ directors. It discourages having more than eight ~~(8)~~ directors, but allows up to ten ~~(10)~~ with the condition that the additional two ~~(2)~~ are independent non-executive directors (BNM, 2004). The BOD is encouraged to include among its members at least one ~~(1)~~ member of the SBSharf'ah Supervisory Board. The purpose of such an appointment is to create a tie between the BOD and the SBSharf'ah Supervisory Body to facilitate understanding and appreciation of *Sharf'ah* among the members of BOD in its decisions and resolutions (BNM, 2010).

~~84-80.~~ The Sudan cooperative model on the other hand requires the composition of the BOD to be consistconsisting of one or two representatives of the participants. The representative(s) are appointed by the participants themselves in the participants' general assembly. Such a requirement gives the participants

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more rights and stronger governance as compared to corporate governance of MPs in other jurisdictions. Additionally, the shareholders also have representatives on the BOD (Archer, Karim, & Nienhaus, 2009).²²

81. Diversity in the qualifications of BOD members is imperative to enable MPs to achieve their corporate goals and fulfil their fiduciary responsibilities. Consequently, the Central Bank of Malaysia in its *Guidelines for Directorship for Takaful Operators* specifies that at least two (2) members of the BOD should be qualified in the field of finance at university degree level, or have had a minimum of five (5) years' working experience at managerial level in the field of finance. In addition, a member of the BOD that sits on the audit committee must have a university degree or working experience in accounting, auditing and financial reporting. The Central Bank of Malaysia encourages the appointment of members to the BOD from various relevant disciplines, including law, accounting and investment management (BNM, 2004). Since the BOD is ultimately responsible for establishing the *Shari'ah* governance framework of MPs, its members are expected to have reasonable understanding of *Shari'ah* and its general application to *Takaful*. The senior management of MPs is responsible for providing the necessary training programmes and seminars to the BOD on *Shari'ah* (IFSB, 2009c) (BNM, 2010).

85.

(iii) Senior Management

86-82. From a purely corporate governance perspective,²³ the senior management²⁴ of MPs is responsible for implementing the medium- and long-term strategies designed to create value for the MP's shareholders. It is also responsible for implementing policies approved by the BOD, and for assisting the BOD to perform its duties by ensuring that board members fully understand matters pertaining to *Takaful* business activities and operations. To ensure the smooth running of MPs' business activities and operations, the senior management has to ensure the proper application of technology and systems in conducting day-to-day activities. Also, as previously mentioned, the senior management needs to provide the BOD with various training programmes inclusive of *Shari'ah* so that it remains abreast of current issues in *Takaful*. The same shall be provided to the SB and all relevant staff of the MPs (IFSB, 2009c) (IFSB, 2009) (BNM, 2004).

87-83. From the *Shari'ah* governance perspective, the senior management is expected to observe and implement resolutions and rulings made by the SB. Additionally, in order for the SB to come up with sound rulings and decisions, the senior management has to provide the SB with sufficient information and disclosures on the matter at hand. The senior management must also ensure that information about *Shari'ah* policies and procedures is readily available to all those involved in the implementation of *Shari'ah* governance in the MPs. Another important aspect of *Shari'ah* governance is reporting of *Shari'ah* non-compliance. The senior management plays a major role in reporting of such events to both the BOD and SB, and, if relevant, to the central bank that governs the MPs (BNM, 2010).

²² The Sudan cooperative model is unique to Sudan, as it combines proprietorship and mutual insurance. Consequently, its structure differs from that of the conventional cooperative insurance model whereby the policyholders are also the shareholders.

²³ The IFSB-14: Standard on Risk Management for Takaful (Islamic Insurance) Undertakings highlights the main four main governance functions, being risk management, actuarial, legal and compliance. The summary of key roles played by these four functions include ensuring that risks are identified and assessed, ensuring prudent pricing and design of products, and ensuring integrity and compliance with regulations.

²⁴ The IFSB-14: Standard on Risk Management for Takaful (Islamic Insurance) Undertakings highlight the main four governance functions, being risk management, actuarial, legal and compliance. The summary of key roles played by these four functions include ensuring that risks are identified and assessed, ensuring prudent pricing and design of products, and ensuring integrity and compliance with regulations.

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~~88-84.~~ The RSA of Nigeria requires the same role as spelled out above to be carried out by the senior management of MPs. It also imposes on the senior management responsibility for ensuring that the SB is remunerated at an appropriate level commensurate with its duties (National Insurance Commission Nigeria, 2013).²⁵

(iv) Shareholders

~~89-85.~~ In practice, the shareholders are represented by the BOD they have appointed to ensure the smooth running of the MPs they own. They get to voice their concerns and to monitor the performance of the MPs through general meetings and annual reports, respectively. There are instances whereby the SB is appointed by the shareholders upon recommendation by the BOD, as seen in the Sudan cooperative model (~~Odierno, 2009; Sulieman, 2014~~) (~~Odierno, 2009~~) (~~Sulieman, 2014~~). The general assembly is also a platform where general policies and rules on governance and management are set (Sulieman, 2014). Such a practice may not be suitable for other models that exist in the industry, especially in jurisdictions such as Malaysia where the authority of SB appointment has been awarded and entrusted to the BOD as required by the RSA (BNM, 2010).

~~90-86.~~ However, According to Archer, Karim and Nienhaus (2009), ~~the shareholders have the ultimate authority to appoint all governance organs of MPs, inclusive of the SB. As in any proprietorship, the shareholders as promoters and owners of the Takāful operator provide the business capital in the form of equity and have full control of the operations. They have the right to appoint all organs of governance in the company – namely the BOD, external auditors, and the Shari'ah Board.~~ They also have full control of the operations of MPs, which entitles them to deciding on matters such as the distribution of any surplus among participants, business strategy, the amount of contribution paid by participants, ~~and more among others.~~ More importantly, it ~~should also be~~ the responsibility of the shareholders to provide the MRF with *Qarḍ* in the event of a deficit. This is to ensure that the MRF remains solvent and is able to make payments of claims when necessary. The practice of providing *Qarḍ* by shareholders to MRF is acceptable to RSAs of Malaysia and Nigeria, and even by the OIC Fiqh Academy. However, the practice of shareholders being the ultimate authority for appointing governance organs and making all decisions concerning the operations of the MPs may be suitable only for those using the mutual model, where the participants are the shareholders.

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(v) Participants

~~91.~~ Participants in *Microtakāful* have needs that differ from those of *Takāful* participants due to their varying socio-economic conditions. ~~Their lack of knowledge of and exposure experience with financial services, and their reduced or total lack of resources of information about the same, make them susceptible to miscommunication leading to misunderstanding, to financial products of MPs, coupled with their limited access to economic information, makes them susceptible to various types of miscommunications.~~ An obvious example would be their misunderstanding of product features. A ~~36~~ Critical Illness Plan that provides coverage for ~~a specific set of listed illnesses, the listed illnesses~~ may be understood by a participant to cover the various stages of illnesses, when in fact it may not necessarily ~~do so be so~~. The fine print of the exclusion section of the certificate may not be easily understood by the participants.

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²⁵ The *Operational Guidelines 2013 Takāful-Insurance Operators*, issued by the National Insurance Commission of Nigeria, are applicable to all *Takāful* Operators, inclusive of *Microtakāful* Operators.

88. Apart from the exclusions in *Microtakāful* products, there may be some confusion about, and misunderstanding of, the underwriting surplus-sharing mechanism, which may be too technical for the participants in *Microtakāful*. Participants should understand that there is a possibility that the underwriting surplus may not be distributed to them in the event it is held back as reserves. This may lead to frustration on the part of participants when a claim arises and benefits are not paid by the MPs. An unfortunate consequence is decreased confidence in the *Microtakāful* system, which was created to protect the low-income segment in the first place. In addition, the demographic spread of participants in areas that are not easily accessible by common means of communication and transportation may also pose difficulties when claims arise. Participants may find the cumbersome claims process not worth the trip to the nearest office of the MP.

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92-89. Many jurisdictions that have initiated *Microtakāful* schemes find merit in simplifying the kinds of documents provided to the participants. To bridge the knowledge gap, Muslim Aid in Sri Lanka conducts a Financial Literacy Training programme for its members who participate in *Microtakāful* plans of Amana *Takāful*. This programme is aimed at providing the members with a thorough understanding of *Takāful*, since it is observed that many of its members lack trust in *Takāful* services and have low understanding of the importance of *Takāful*. When *Microtakāful* products were first launched, many members had the initial perception that *Takāful* is a savings option, rather than a protection option. In addition, Amana *Takāful* simplified its product literature to enable the *Microtakāful* participants to easily comprehend the terms and conditions of the coverage. On 9 July 2014, Amana *Takāful* launched its new mobile application for iPhones and Android devices. This application, which is made available at no cost, provides Amana *Takāful* participants with the means to access their account details online. The application also aims to make the claims process easier through supporting photos provided by the participants. (ICMIF *Takāful*, 2014a) (ICMIF *Takāful*, 2014).

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90. While easy access to *Microtakāful* is the aim of MPs, the type of distribution channels used to reach the participants, if not monitored by the RSAs or regulator of formal entities, may lead to miscommunication. Consumer protection is hence a feature that needs careful consideration when positioning for an appropriate communication tool to reach the low-income population.

93.

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(vi) *Shari'ah* Board

94-91. The requirement to comply with *Shari'ah* principles is as significant for *Microtakāful* as it is for normal *Takāful* products. Many potential *Microtakāful* participants find Islamic financial products more welcoming and encouraging as compared to the conventional financial products, due to the absence of *Riba*, *Gharar* and *Maysir* elements, especially in *Takāful*. There is hence the need to ensure that the *Shari'ah* principles are adhered to in all aspects of *Microtakāful* operation. Individual MPs can address such a need by establishing an internal SB. Certain RSAs in jurisdictions such as Malaysia, Nigeria and Pakistan have set up central *Shari'ah* Advisory Boards to ascertain the Islamic law that governs the business and operational activities of MPs. In addition to the central *Shari'ah* Advisory Board, MPs operating in the aforementioned jurisdictions are required by their RSAs to establish an internal SB to oversee *Shari'ah* matters related to their business activities and operations. In countries such as Sri Lanka and Kenya, where the MPs operate in the absence of a central SB at the RSA level, they rely solely on their internal SB. Consequently, the SB discussed in the following paragraphs refers to an internal SB.

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95-92. While the ideal scenario is one where MPs comply with *Shari'ah* principles, it may not be easy or practical to carry out such a requirement. In a jurisdiction where MPs are not regulated under the same RSAs as the TOs, or where there is no requirement to have a *Shari'ah* governance framework in place, the challenge will be in ~~satisfying oneself ensuring~~ that the products of these MPs are indeed *Shari'ah* compliant. If a monitoring mechanism is not in place, the sanctity of *Microtakāful* products will become easily questionable by the public at large.

96-93. For MPs regulated by the RSAs, the ~~Shari'ah Board~~ SB often ascertains the *Shari'ah* compliance of the *Microtakāful* products through a similar screening process done on normal *Takāful* products. The Central Bank of Malaysia's *Shari'ah Governance Framework for Islamic Financial Institutions* requires all Islamic financial institutions to have "a robust *Shari'ah* compliance function, comprising review and audit functions supported by risk management control process and internal research capacity" (BNM, 2010). This is complemented by the Central Bank's *Takāful Operational Framework*, which requires all ~~Takāful Operators~~ TOs to have in place a comprehensive product development process that includes certification by the ~~Shari'ah Board~~ SB prior to offering any type of product to the market (BNM, 2013).

94. Consistency in *Shari'ah* governance is ~~in the interpretation of *Shari'ah* rules and principles based on the science of Islamic jurisprudence is~~ pertinent to the growth of the *Microtakāful* industry, as it encourages confidence by participants in the industry. ~~During the product development stage, after a product design and proposal has gone through a rigorous internal review process, it would be presented to the SB for its deliberation and approval. In arriving at a decision, When determining the *Shari'ah* compliance of a product,~~ members of the SB should seek to reach a consensus; if that cannot be achieved ~~within a reasonable period of time~~, then the members should resort to a decision by a simple majority. ~~Additionally, members of the SB must ensure that their opinions and decisions are consistent with those expressed and made on SBs in different institutions offering Islamic financial services (IFSB, 2009c).~~

97-95. ~~The issuance of *Shari'ah* pronouncement should comply with the legal and regulatory framework of jurisdictions where the MPs operate. To achieve consistency, the members of the SB should study and take into consideration the decisions of other SBs before issuing a pronouncement.~~ The SB should follow and adopt the pronouncements of a central SB where ~~ver~~ relevant. If a central SB is not established where the MPs are operating, then the SB should rely on pronouncements of internationally recognised bodies. Where there is no decision on a particular issue, and the SB has to come up with its own decision, then such a decision should be documented and published so that it can be easily accessed by the industry's stakeholders (IFSB, 2009c).

98-96. Apart from approving *Microtakāful* products, the SB is expected to give binding opinions and decisions relating to the business and operations of MPs and shall be responsible and accountable for the decisions made and opinions expressed. The SB plays the role of overseeing *Shari'ah* matters pertaining to the business operations and activities of MPs via *Shari'ah* review and *Shari'ah* audit exercises conducted by internal units undertaking the *Shari'ah* compliance functions. At the end of the financial year of MPs, the SB has the important function of disclosing the state of *Shari'ah* compliance of MPs in the respective financial statements (BNM, 2010).

Other pertinent responsibilities of the SB are as follows (BNM, 2010; Billah, 2009) ~~(BNM, 2010) (Billah, 2009)~~:

- endorsing policies and procedures;
- endorsing and validating documents, including but not limited to *Microtakāful* certificates, proposal forms, *Aqd* forms, product disclosure sheets, and marketing collateral;

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- assessing reports and work executed by *Shari'ah* review and *Shari'ah* audit units;
- providing written *Shari'ah* opinions in the event a central *Shari'ah* Advisory Board requires more *Shari'ah* justification on product approvals given to MPs;
- examining and endorsing *ReTakaful* arrangements and contracts; and
- monitoring investments of MRF and SHF.

99-97. The composition of SB is crucial in ensuring that the aforementioned roles and responsibilities are carried out efficiently and effectively. According to the Central Bank of Malaysia, the SB of every individual MP shall consist of at least five ~~(5)~~ members, the majority of whom hold at least a bachelor's degree in *Shari'ah*. Diversity in the SB is recommended; therefore, the SB may be comprised of experts from various disciplines other than *Shari'ah* but they shall not form its majority. In addition, the members of the SB shall be persons of acceptable reputation, character and integrity, and be nominated by the nominating committee and approved by the BOD ~~(IFSB, 2009b; BNM, 2010) (IFSB, 2009) (BNM, 2010)~~.

100-98. The National Insurance Commission of Nigeria, on the other hand, requires the SB to consist of at least three ~~(3)~~ members. MPs must appoint a minimum of one ~~(1)~~ insurance expert, and two ~~(2)~~ *Shari'ah*-qualified scholars (National Insurance Commission Nigeria, 2013). Pakistan takes a slightly different approach. MPs within the Pakistani jurisdiction do not have to establish an SB, as the appointment of at least one ~~(1)~~ *Shari'ah* adviser with expertise in *Shari'ah* is sufficient to oversee the *Shari'ah* aspects of the MPs' operational matters and business activities (Securities and Exchange Commission of Pakistan, 2012). Taking into account the financial limitations of MPs, a research study suggests that MPs may appoint a minimum number of three ~~(3)~~ members to establish an SB (Mokhtar, Sulaiman, & Ismail, 2012). This is very much in consonance with the requirement imposed by the National Insurance Commission of Nigeria.

101-99. MPs regulated by the Central Bank of Malaysia are required to establish four ~~(4)~~ key *Shari'ah* governance functions, namely *Shari'ah* research and secretariat, *Shari'ah* risk management, *Shari'ah* review and *Shari'ah* audit. All these functions report to the SB ensuring end-to-end *Shari'ah* compliance of MPs' business operations and activities. The *Shari'ah* research function undertakes review of product proposals, research on *Shari'ah* issues, and secretarial matters pertaining to the SB. The role of the *Shari'ah* risk management function is to mitigate any possible *Shari'ah* non-compliant events by systematically identifying, measuring, monitoring and controlling *Shari'ah* non-compliance risks (BNM, 2010). Nigerian MPs, on the other hand, are not required to have their own internal *Shari'ah* research function. In fact, the responsibility for carrying out this task is shouldered by the SB, rather than by a unit established by the management of MPs. A *Shari'ah* compliance unit that executes similar duties of *Shari'ah* review as described in paragraph 98 could act as a secretariat to the SB (National Insurance Commission Nigeria, 2013).

102-100. The *Shari'ah* review function is responsible for conducting regular evaluation of the *Shari'ah* compliance of the MPs' business activities and operations. Such evaluation will be reported to the SB for it to determine and confirm the *Shari'ah* compliance status of a certain business activity or operational matter. Consequently, the *Shari'ah* review function will be involved in the remedial rectification plan in the event that a *Shari'ah* breach has occurred. Such a rectification plan must be approved by the SB. The *Shari'ah* audit function, on the other hand, carries out periodic assessments of the business activities and operations of MPs. A comprehensive internal *Shari'ah* audit programme is developed to provide independent assessment of the degree of *Shari'ah* compliance employed by the MPs (BNM, 2010).

103-101. The *Operational Guidelines 2013 Takaful-Insurance Operators* spell out the responsibilities of the *Shari'ah* compliance unit in great detail. Its responsibilities include ensuring the segregation of

Microtakāful funds, ensuring that the management of the MRF deficit complies with *Shari'ah* principles, ensuring that payments of commissions and expenses are made from the MRF, and more. Unlike the *Shari'ah Governance Framework*, members of the SB of Nigerian MPs are expected to conduct the *Shari'ah* audit function, with a condition that they are involved in product approval. Alternatively, the SB could appoint an audit firm to perform this task (National Insurance Commission Nigeria, 2013).

104-102. In the event that the MP is not capable of having its own internal SB and *Shari'ah* governance functions, such functions must be outsourced to a third party, namely a *Shari'ah* advisory firm. A *Shari'ah* advisory firm should have sufficient expertise and resources to carry out its work. (IFSB, 2009c) (IFSB, 2009). In the Malaysian context, outsourcing of the *Shari'ah* governance function is only limited to *Shari'ah* audit, which is also subject to the condition that the MPs are satisfied with the comprehensiveness and scope of the audit.

105-103. For MPs regulated by entities other than the RSAs, where monetary assistance is in the form of government subsidies or charitable donations, compliance with *Shari'ah* principles may pose a challenge if there exists no formal *Shari'ah Board* SB to oversee the compliance requirement. For *Takāful* Mikro Indonesia (Takmin), the partnership between Peramu and *Takāful* Indonesia obtains the involvement of Baytul Maal, which is a trust fund institution responsible for pooling funds and distributing them to the poor. Given the nature of Baytul Maal as a State Treasury in charge of managing the assets of the state in accordance with *Shari'ah* principles, Takmin possesses its own SB and would use a screening mechanism when it comes to the initial screening of eligible recipients. Baytul Maal needs to ensure that the money distributed for *Zakah*²⁶ or *Sadaqah*²⁷ fulfils the requirements of the appropriate *Asnāf* (categories).²⁸ For the second layer of screening, *Takāful* Indonesia, being the product developer of Takmin *Microtakāful* products, has its own internal SB for product development approval. In an arrangement of this type, there is the possibility of a conflict arising between the decisions made by the different SBs, such as by the *SB Shari'ah Board* of Baytul Maal and that of *Takāful* Indonesia. The issue may arise as to which decision is superior in a *Shari'ah*-related matter.

106-104. For MFIs offering *Microtakāful* products under no formal supervision of the local RSAs, such as the example cited from Sri Lanka where deregulation of the insurance sector allows for new MPs, questions will always arise about the sanctity of *Microtakāful* products' compliance with *Shari'ah* principles. The MFIs may be offering the *Microtakāful* products under their own initiatives and have limited understanding of *Shari'ah* compliance requirements. This raises the question of whether *Shari'ah* compliance should be compromised for the purpose of expansion of *Microtakāful* initiatives.

(c) Application of IAIS' Insurance Core Principles

107-105. The IAIS in its papers *Application Paper on Regulation and Supervision Supporting Inclusive Insurance Markets* provides guidance on how its Insurance Core Principles may be implemented

²⁶ *Zakah* is an obligatory act required by Islam to be performed by every adult and able-bodied Muslim. It is an important pillar among the five pillars of Islam. *Zakah* is a part of the wealth and property that Muslims must pay annually, to help the poor of their community. One of the main purposes of *Zakah* is to keep those who are wealthy clean, monetarily, from sin. It is a form of charity that is obligatory for Muslims.

²⁷ *Sadaqah*, on the other hand, means voluntary charity, the opposite of *Zakah*, which is obligatory.

²⁸ Under the obligatory payment of *Zakah*, only eight categories of society are eligible to be the recipients of this fund. They are: (a) those living without a means of livelihood; (b) those who cannot meet their basic needs; (c) *Zakah* collectors; (d) new Muslim converts; (e) those wishing to be freed from slavery or servitude; (f) those who have incurred overwhelming debts while attempting to satisfy their basic needs; (g) those fighting for a religious cause or a cause of God; and (h) wayfarers and stranded travellers.

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to enhance the inclusivity of insurance markets. The proportionality principle has been taken to be the appropriate mechanism for applying ICPs to the microinsurance framework to reflect the nature, scale and complexity of the business framework. The proportionality principle aims to justify (a) simpler and less burdensome ways of meeting requirements for low-risk activities, and (b) more sophisticated methods and techniques for more complex risk situations (IAIS, 2012).

~~108-106.~~ For ICPs relating to corporate governance and the interests of microinsurance stakeholders, the application of procedural proportionality requirements is found to be relevant in ICP 5: *Suitability of Persons*²⁹ and ICP 7: *Corporate Governance*.³⁰ The former ICP requires that the board members, senior management, key persons in control functions and significant owners of an insurer must have pertinent experience and maintain a sufficient degree of knowledge, while the latter provides a corporate governance structure through which an insurer is managed and controlled. It is worth highlighting that “proportionality” from the perspective of IAIS does not translate to the introduction of automatic and systematic simplifications for insurers or intermediaries. The proportionality measure taken by the RSAs should at least be suitable, necessary and appropriate to attain the supervisory objectives of a jurisdiction. Most importantly, the system must remain supervisable.

~~109-107.~~ While this proportionality approach may similarly be applied by the MPs of *Microtakāful* to their governance framework, RSAs need to be aware of the existence of other MPs that are not regulated by them but, rather, by other formal entities, as well as those MPs that may not be regulated at all. Where *Microtakāful* initiatives are subsidised by the government, the ideally supervised environment of the RSAs may in certain circumstances be jeopardised. This holds true if the MPs are required to participate in a national *Microtakāful* scheme where pricing is somewhat prescribed by the local authority rather than determined by prudent pricing as stipulated by the RSAs.

II. Financial and Prudential Regulation

(a) Sharī'ah Compliance Requirements

~~110-108.~~ *Microtakāful* is launched under the same premise as *Takāful*, which is to comply with *Sharī'ah* principles. It aims to rid the existing insurance system of three main elements: *Maysir* (gambling), *Gharar* (uncertainty) and *Riba* (usury). While it may seem straightforward for MPs simply to follow the requirements set forth for TOs to ensure that their operational activities are *Sharī'ah* compliant, the practical approach may not be as easy as it should be, since the stakeholders vary between MPs and TOs.

~~111-109.~~ For MPs that are regulated by the RSAs, the licensing requirement may require them to have an internal *Sharī'ah* Board or to comply with the RSA's ~~SBS~~*Sharī'ah Board* requirements prior to being offered a licence. For MPs that are not regulated by the RSAs, the absence of a licensing requirement may accord flexibility to these providers in terms of ensuring strict compliance with *Sharī'ah* principles. This might lead to reputation risk when a breach of *Sharī'ah* principles is discovered.

~~112-110.~~ IFSB-10: *Guiding Principles on Sharī'ah Governance Systems for Institutions Offering Islamic Financial Services* provides guidance on the development of a *Sharī'ah* governance framework which may be made reference to by MPs wishing to have in place a *Sharī'ah* operational, screening and

²⁹ ICP 5 states: “The supervisor requires Board Members, Senior Management, Key Persons in Control Functions and Significant Owners of an insurer to be and remain suitable to fulfill their respective roles.”

³⁰ ICP 7 states: “The supervisor requires insurers to establish and implement a corporate governance framework which provides for sound and prudent management and oversight of the insurer’s business and adequately recognizes and protects the interests of policyholders.”

review framework. MPs that are not regulated by RSAs may opt to establish their own internal **SB~~Sharī~~ah Board** for the purpose of having an internal *Sharī*ah review mechanism for all their products, or they may choose to refer to a local **SB~~Sharī~~ah Board** which may provide guidance on *Sharī*ah compliance issues relating to *Microtakāful* products. Whichever SB these MPs wish to put in place, there need to be clear terms of reference regarding ~~the SB~~'s mandate and responsibility, well-defined operating procedures and line of reporting, plus a good understanding of, and familiarity with, professional ethics and conduct. In addition, the individual mandated with overseeing the *Sharī*ah governance systems must fulfil acceptable "fit and proper" criteria (~~IFSB, 2009c~~) (~~IFSB, 2009~~).

113-111. A focus group discussion conducted by the Securities and Exchange Commission of Pakistan (SECP) in 2012 with a group of low-income microfinance customers revealed that, in a country where 96% of its population are Muslims, the preference for *Microtakāful* over microinsurance products is the main reason why the penetration of microinsurance is low in that country (Amjad, 2013). Consequently, in February 2014, the SECP issued the Microinsurance Rule 2014, which is applicable to the *Microtakāful* industry. Prior to the issuance of Microinsurance Rule 2014, the SECP established in 2013 a centralised *Sharī*ah Advisory Board. The ***Sharī*ah Advisory Board** will oversee the application of Islamic finance rules to instruments including mutual funds, pension funds and *Takāful*. In addition, ~~the *Sharī*ah Advisory Board~~ will be in charge of recommending accounting and investment guidelines apart from undertaking educational activities (Securities and Exchange Commission of Pakistan, 2013).

(b) Requirement for Separation of Funds

112. In the most commonly used model of *Takāful*, separation of funds between the Shareholders' Fund and the Participants' Risk Fund (**Participants' Risk Fund**) is a key requirement in fulfilling the *Sharī*ah principles. As stipulated in IFSB-11, "The distinctive rights and obligations between the TO and *Takāful* participants require a clear segregation of the PRF from the TO's shareholders' fund" (IFSB, 2010). A similar argument is valid for *Microtakāful* operations, since, in the absence of misconduct or negligence, the MP is not contractually accountable for any deficit or loss arising from an MRF.³¹ This is also done on the precept that the SHF belongs to the shareholders and the PRF belongs to the participants, from which fund claims and claims-related expenses will be paid.³² Under this principle, failure to separate the fund may render the *Takāful* operation non-*Sharī*ah compliant. It is thus crucial for MPs to ensure that this key requirement is understood comprehensively when choosing the type of *Microtakāful* model to be used for its operation.

114.

³¹ While a TU is expected to maintain the separation of funds, the PRF of a TU has to remain solvent to be able to meet its participants' claims and other financial obligations. The AAOIFI Standards spells out four (4) approaches to deal with deficit within PRF

- Cover the deficit from the reserves within PRF;
- Borrow funds from the PRF by way of Qard, which is repaid from future surpluses;
- Ask the participants to cover the deficit in proportion to their individual contribution; and/or,
- Increase future contributions of the participants proportionally

In dealing with deficit, the common practice is to carry out a hybrid of the first two (2) approaches. The two (2) latter options on the other hand are not viable. The first of the latter two (2) options is impractical as TOs or MPs are required to approach every single participant to ask them to inject additional capital to meet the deficit. The second of the latter two options on the other hand contradicts the principle of inter-generational equity.

³² Paragraph 37 of IFSB-11 states that "Some *Takaful* products may be written in so-called ring-fenced funds, where part of the business is clearly segregated from the rest. In such cases the assets or retained underwriting surplus of the fund may be strictly isolated from the other lines of business so that they can only be used to meet the *Takaful* and *Retakaful* obligations with respect to which the ring-fenced fund has been established."

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(c) Sharing of Surplus

113. Surplus sharing is an element of *Takāful* that is still being deliberated upon at length by the *Takāful* industry. Well known for its unique payback feature, many industry players still use this mechanism for sharing any surplus with participants as an enticement feature to attract the general public to participate in *Takāful* plans. This is especially obvious in General *Takāful* products, which are renewable annually. It is usually at the end of the certificate term that any surplus generated from the PRF will be shared between the participants and the shareholders of the TOs. As envisaged in IFSB-8, any surplus generated from the PRFs will usually be shared according to a pre-agreed percentage between the shareholders and the participants. The portion allocated to participants will either be distributed to the participants themselves or be retained in the PRF to build up the reserves to strengthen the fund for solvency purposes (IFSB, 2009a).

114. According to AAOIFI's *Shari'ah Standards for Islamic Financial Institutions*, distribution of surplus can be in one of the following forms:

- distribution of surplus among participants in proportion to their respective contributions regardless of whether or not they have made claims during the financial period;
- distribution of surplus among participants who have not made claims during the financial year;
- distribution of surplus among participants after deduction of claims they have made during the financial year; or
- distribution through any other method approved by the Shariah Boards of respective MPs

115. Although the issue with regards to surplus sharing remains the responsibility of the *Shari'ah* Board (SB) of each jurisdiction and is likely also to remain an issue for MPs, it is not this feature that is creating concern among MPs and their stakeholders. The real predicament is whether the surplus should be distributed to the participants or be required to remain in the MRF. One study suggests that there is a strong link between MPs' duration (i.e. number of years) of operation and level of surplus in the MRF. Consequently, MPs operating more than ten years are in better surplus position than MPs operating less than ten years (Mokhtar, Aziz, & Hilal, 2015). Notwithstanding that, in a sector where the obligation to honour claims is much higher than the imperative to make a profit out of product offerings, the need to ensure sufficiency of the MRF places a greater burden on the MPs. This makes it even more crucial for solvency of the MRF to be observed. To achieve this, some MPs argue that the most appropriate mechanism is to retain any surplus in the MRF. The objective of surplus retention must be disclosed to participants to ensure that transparency is observed, especially in practices where participants are not represented in the corporate governance of the MPs.

116. However, whether this approach is feasible or practical remains an open question that needs to be answered by MPs and their RSAs. There needs to be proper judgment on whether it is more viable to retain a surplus in the MRF (to build the capital strength of the fund) or to distribute it to the *Microtakāful* participants (in an attempt to increase their interest in products that have a payback feature). An alternative practised in certain jurisdictions is to direct the surplus to the general welfare of the low-income group or to enhance the benefits of the product. This practice provides the low-income group with a general sense that they are gaining something back through the enhanced benefits and better welfare. Another suggestion is that it may be more appropriate for any surplus to be ploughed back as *Tabarru'* for additional personal accident cover, since the amount of surplus generated from the small contribution of *Microtakāful* participants does not normally count as a form of savings for this low-income population. They would benefit more if extended coverage were provided (Mokhtar, Sulaiman, & Ismail, 2012).

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117. An example of surplus being distributed is the declaration of a surplus by *Takāful Insurance of Africa* (TIA) in Kenya, whereby all its policyholders, including the *Microtakāful* participants, received a total of US\$120,000 for the financial year ending December 2012 (Chao-Blasto, 2014). TIA believes that “surplus distribution is the beauty of *Takāful* and a testimony to *Shari’ah* compliance, fairness and equity of the process” (Takaful Insurance of Africa, 2013).

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(e)(d) Solvency and Capital Adequacy Framework

115-118. The nature of the *Microtakāful* market segment calls for the need to have a different regulatory requirement. This is intended to ease market participation by the low-income section of the population which, under normal circumstances, is excluded from the financial system.

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116-119. IFSB-11: *Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings*, issued by the IFSB in December 2010, lists seven key features to be observed by the TOs and RTOs. They are as follows (IFSB, 2010):

(i) **Key feature 1:** The solvency requirements for *Takāful* undertakings (TUs) must adopt a total balance sheet approach to ensure that risks are appropriately recognised and consistently valued, and to identify the interdependence between assets, liabilities, regulatory solvency requirements for PRF and the shareholders' funds of the TO. However, the total balance sheet approach must address the clear separation of PRF and the shareholders' funds of the TO.

(ii) **Key feature 2:** The solvency requirements should be established at a level such that the respective amounts of solvency resources in the *Takāful* and shareholders' funds are adequate to meet their respective financial obligations as they fall due, bearing in mind that part of the shareholders' funds may be “earmarked” to cover a *Qard* facility.³³

(iii) **Key feature 3:** The solvency requirements should establish solvency control levels at the respective *Takāful* and shareholders' funds, which trigger proper interventions by the TO and the supervisory authority when the available solvency is less than the solvency control level.

(iv) **Key feature 4:** The solvency requirements should establish criteria for assessing the quality and suitability of solvency resources in the *Takāful* and shareholders' funds to absorb losses in different financial stages of the respective funds.

(v) **Key feature 5:** The solvency requirements for *TU Takāful undertakings* must have separate risk-adjusted computation and assessment. The risk management framework must be comprehensive and cover all risks to which the PRFs and the shareholders' funds are exposed.

(vi) **Key feature 6:** The adequacy of regulatory solvency requirements for a *Takāful undertaking TU* depends on the maintenance of a sound risk management framework. An essential part of the supervisory review process is to assess for each undertaking that adequate risk management arrangements are in place through which the TO can, and does, monitor, measure, report and control the management of the assets and liabilities in a coherent and integrated manner.

(vii) **Key feature 7:** Information regarding the solvency requirements for a *Takāful undertaking TU* that is material and relevant to the market participants should be publicly disclosed to enhance market discipline and the accountability of the TO.

³³ In the event the PRF is in a deficit, a *Qard* facility is drawn down from the SHF and injected into it in order for the TU to continue its operations. The SHF undertakes to provide *Qard* to the PRF although it is expected for a TU to maintain the separation of funds. *Qard* is to be repaid out of future surpluses of the PRF. This is the current practice of most jurisdictions offering *Takāful* and *Microtakāful*.

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120. While it is ideal for RSAs to require MPs to observe each of the seven key features, the RSAs need to consider the size, complexity and nature of the risks absorbed by MPs into their institution. The issues that may be prevalent for normal TOs may not be so for MPs. An example would be the requirement to have two solvency control levels for each of the risk fund and the SHF. For MPs, some of which may not be under the regulation of *Takāful* RSAs, this requirement may be burdensome since a higher amount needs to be set aside to meet the various solvency control levels unless lower amounts are allowed from a perspective of proportionality, as is shown in the next paragraph. The small amount received as a contribution that has already been set at its lowest level may not allow the MPs sufficient excess to meet two levels of solvency requirements. Also, requiring MPs to meet these two levels of solvency would increase the cost of providing the *Microtakāful* products. This is an area that requires careful thought by the RSAs. What is ideal under a secured financial system may not be so when it comes to a more or less risky group of participants.

117-121. In considering a separate solvency regime for MPs, it is pertinent for the RSAs to consider the procedures for dealing with insolvent winding-up of an MP. Furthermore, the legal and regulatory framework should provide for the determination of the point at which it is no longer permissible for a *MicroTakāful* undertaking to continue its business.

118-122. In the Philippines, for example, microinsurance schemes that operate under mutual benefit associations (MBAs) are allowed by the Insurance Commission of the Philippines to operate under lower minimum paid-up capital. For example, for an existing local insurer to run a business based on a traditional insurance licence, the minimum paid-up capital required is US\$1.7 million, whereas for a new MBA to start offering a microinsurance plan, the initial paid-up capital required is only US\$113,000. This amount, however, is expected to increase annually by 5% of the MBA's total collected annual premiums, with the ultimate aim of acquiring 12.5% of the minimum paid-up capital of a local insurer (Hafeman, 2009). The Insurance Commission is also the RSA that will determine the assumptions that will be used for the pricing of the microinsurance products. These include the maximum administrative expenses and investment yield, surrender rates, the minimum surrender benefit, and the minimum amount that needs to go into the guarantee fund. Although the products and premium rates are pre-approved by the Insurance Commission prior to being offered to the market, there have been cases where the price offered to the microinsurance participants deviated from the price approved by the Insurance Commission.

(d)(e) Risk Management Framework

119-123. Another requirement to be considered by the MPs is the risk management framework. IFSB-14: *Standard on Risk Management for Takāful (Islamic Insurance) Undertakings* provides a general framework for TOs containing (IFSB, 2013):

- risk policies and strategies;
- risk identification;
- risk assessment, response and control;
- control framework;
- risk monitoring; and
- risk reporting.

120-124. While putting in place a risk management framework specific to MPs is crucial in enabling the providers to ensure that all risks that are exclusive to *Microtakāful* participants are captured and recorded in the risk register based on the nature, scale and complexity of the business, it may not

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necessarily be easily implemented by MPs. MPs that are not regulated by the RSAs may not possess the required expertise to assess the risks and put in place an appropriate control framework. They may not be aware of the risks that are specific to *Microtakāful*, such as the risk of *Sharī'ah* non-compliance and the risks arising from the separation of SHF and MRF funds (IFSB, 2013).

~~121-125.~~ In addition, the various intermediaries involved in the chain of business and the types of possible moral hazards implicated in providing coverage to the *Microtakāful* participants may also not be captured into the risk management framework. These intermediaries may include small pawn shops and grocery stores which, under normal circumstances, are not licensed by any RSAs or regulators of formal entities. This is where the gap is, and mechanisms would need to be developed to capture the kinds of risks that unregulated intermediaries bring into the financial system.

~~122-126.~~ In terms of the types of products offered to the *Microtakāful* participants, the risk weights carried by these participants need to be reflected in the pricing of the products. This is normally taken care of if mortality tables that are approved by the RSAs are used in the pricing, with appropriate expense assumptions loaded into the pricing mechanism. This is crucial in ensuring the funds are sufficient to meet all possible claims made by *Microtakāful* participants. However, for MPs that are not regulated by the RSAs, inappropriate pricing may lead to insufficient MRF, which may eventually lead to inability of the MRF to meet its claims obligations. There needs to be a mechanism to ensure that these MPs possess the minimum pricing knowledge for sustainability of the MRF.

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~~(e)(f)~~ **Investment Framework**

~~123-127.~~ Given ~~the nature of that~~ MPs ~~being are~~ created to provide coverage to *Microtakāful* participants, appropriate investment policies are crucial for all their product lines, taking account of the diverse characteristics of the liabilities of each category and the acceptable risk tolerance for each category and for the *Microtakāful* participants. The investment framework of MPs needs to provide ~~for~~ sufficient cash flow to support ~~for possible the~~ immediate need of the funds. In addition, the primary needs of MPs ~~are on the~~ support ~~on for~~ their growth, therefore they need to be assured that the business has appropriate investment backing along with technical skills to support downscaling while at the same time improving the ~~re~~ low-income market focus.

~~124-128.~~ While the investment policies are common in MPs regulated by RSAs, they may not exist in MPs that are not regulated by the RSAs. Some of these MPs may not be aware that the *Microtakāful* participants are the ose ~~ones~~ who will bear the investment risk and other associated risks. Since *Microtakāful* participants are not involved in the management of the *Microtakāful* funds, they cannot exercise their rights as owners of the funds. This is an important aspect that may be overlooked by the MPs. Another important aspect that requires careful consideration is the process of selecting or purifying assets to achieve *Sharī'ah* compliance. An MP that lacks knowledge of the requirements for *Sharī'ah*-compliant investment return may not be able to assess if the income received is tainted by being derived from impermissible activities or questionable sources.

~~(f)(g)~~ **Underwriting Requirements**

~~125-129.~~ The underwriting requirements for normal TOs usually involve various processes of understanding and classifying the types of risks absorbed by TOs. This process is to ensure that the risks

taken on are risks that are not detrimental to the survival of the organisation. This process normally involves mortality and morbidity tables in which statistics ~~from previous decades~~ of survival and death of the insured ~~from the past decades~~ are compiled and ~~made reference~~referred to in ~~coming up with~~ pricing of products. In addition, understanding risks includes making a thorough background check on ~~the~~ potential participants prior to accepting them into the pool of risks. This is normally done when ~~TOs~~ selected high-risk participants are sent for a thorough medical check-up ~~by the TOs~~. Some of the key criteria in the underwriting process include health, build, cholesterol, blood pressure, cancer history, tobacco, alcohol or substance use, hazardous activities or occupations, driving history and family history. An individual's financial background, as well as types of coverage required, will also be key considerations in the application process.

~~126-130.~~ While it is common for RSAs to impose strict underwriting requirements on TOs, it may not be practical to impose similar requirements on MPs. The demographic and educational background differences between the low-income and average-income participants make the *Microtakāful* participants more prone to various kinds of hazardous occupations and sicknesses ~~that may not be commonly found in middle income earners~~. At the same time, the limited exposure that they get with regards to maintenance of good health makes them more susceptible to various health conditions that will lead to higher contributions if they were underwritten in the same way as the normal *Takāful* participants. In addition, these participants' irregular income makes financial underwriting a deterrent for them being accepted. It is for this simple reason that the low-income segment has thus far been broadly excluded from the normal financial products offered by the existing TOs.

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~~127-131.~~ For *Microtakāful* initiatives to be expanded to include the low-income population, the RSAs and other relevant authorities may have to encourage a more flexible financial environment in which these potential clients may go through simplified underwriting requirements while enabling them to be sufficiently assessed. To offset the risky downside of these participants, RSAs may instead limit the amount and type of coverage that may be provided to ~~these participants~~, provided that this is not done at the expense of product innovation. The array of products to be offered should also be limited to those that are simple to understand, so that participants will not have difficulty in comprehending the coverage being offered.

~~(g)(h)~~ Application of IAIS' Insurance Core Principles

~~128-132.~~ While the expansion of the *Microtakāful* industry has not reached the level of coverage enjoyed by its conventional counterpart (i.e. microinsurance), there is an advantage in knowing that the regulatory challenges and issues faced by the microinsurance sector are similar. Thus the IAIS proportionality principle offers good guidance, especially in jurisdictions where regulations of microinsurance, if it exists, may be referred to while also taking into consideration the specificities of *Microtakāful*.

~~129-133.~~ Under the procedural proportionality of ICP 17 on capital adequacy and ICP 16 on enterprise risk management, special consideration is given to inclusive insurance markets for the underserved, although exemption is not an option. However, this requires an approach that reflects the nature, scale and complexity of the risks. The absolute minimum bound for the Minimum Capital Requirement may be revised to a lower level that reflects its lower risk profile as well as more limited need for detailed governance and risk management. ICP 16 may also be applied by limiting the activities and prescribing specific requirements focused on the nature of risks undertaken and underwritten and capable of being economically implemented for small, low-risk, less complex insurers so as to deliver the intent of ICP 16.

~~130-134. With respect to the ICP on investment (ICP 15) the following factors are worth considering is not specifically mentioned under the proportionality principle, its interconnection with ICP 17 makes the following factors worth considering in establishing the regulatory investment requirements for microinsurance: (a) quality of risk management and governance framework, (b) quality of capital resources, (c) comprehensiveness and transparency of disclosure frameworks, (d) development of relevant investment and capital markets, (e) cost of compliance, (f) competition with other financial services institutions, and finally, (g) the level of prudence and risk sensitivity of the regulatory solvency requirements.~~

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~~131-135.~~ Although these ICPs may be applied principally to *Microtakāful*, it is crucial for the RSAs of MPs to consider the specificities of *Microtakāful* in formulating regulations and guidelines for *Microtakāful*. This is essential especially when it concerns the compliance with *Sharī'ah* principles, such as the requirement to ensure separation of SHF from the MRF, as well as the *Sharī'ah* governance framework that is required in overseeing the operational activities of MPs.

~~132-136.~~ The risk of *Sharī'ah* non-compliance is pervasive in the operations of an MP – for example, its product cycle. Since all *Microtakāful* products need to be *Sharī'ah* compliant, the overall product development process therefore requires consideration of *Sharī'ah* compliance, including the stages where products are priced, underwritten, advertised, contracted and finally accepted by the participants. These require careful consideration on the part of the MPs and their RSAs.

III. Transparency, Reporting and Market Conduct

(a) Customer Education and Awareness

~~133-137.~~ Educating the low-income population about the importance of financial protection has always been a challenge for insurance companies and TOs. This is especially so when the income stream of the low-income population is irregular. Some low-income earners may not even have a decent income for a certain part of the year, especially when they are directly involved in agricultural activities that are easily affected by weather conditions. For *Microtakāful* initiatives to grow bigger in an attempt to widen the scope of financial inclusion, the RSAs and relevant authorities may wish to play a supportive role in encouraging the MPs to increase their education and awareness activities in areas saturated with low-income earners.

~~134-138.~~ Information asymmetry is currently the predicament faced by both the MPs and *Microtakāful* participants. The MPs are uncertain of the types and behaviours of risks that they absorb into their financial system, due to the lack of mortality and morbidity statistics on the low-income population. On the part of *Microtakāful* participants, there is a lack of awareness and understanding of the importance of *Takāful* protection. This information asymmetry on both sides of supply and demand has created a gap which, to date, both sides have been unable to bridge. Various types of initiatives may be conducted and supervised by the RSAs and relevant government agencies to increase awareness among the low-income population.

~~135-139.~~ In Indonesia, an awareness programme for *Microtakāful* is conducted by the Islamic Economic Society (MES) as part of its 2014 initiative to integrate the efforts made by MPs and Baitul Maal wa Tamwil (BMT).³⁴ The Islamic Micro Insurance Business Matching Event was a series of roadshow

³⁴ Baitul Maal Wat Tamwil is a financial institution in Indonesia that provides a financing facility to small entrepreneurs to finance their business operations. These small entrepreneurs usually do not have access to the larger banking sector

events held between 2013 and April 2014 in six cities in Indonesia, namely Batam, Padang, Banjarmasin, Palangkaraya, Medan and Cirebon. The objective of the roadshow was to increase BMTs' awareness of the importance of risk mitigation through *Microtakāful* products. MES felt the need first to educate BMTs on the importance of *Microtakāful* so that the information might be transferred to the recipients of BMT funds throughout Indonesia. From this awareness programme held by the MES, a total of 20 BMTs in Malang, 4 BMTs in Batam and 41 BMTs in Padang started to increase awareness of the use of *Microtakāful* products among recipients of funds from BMTs (Hamzah, Rusby, & Hamzah, 2013).

(b) Consumer Protection

~~136-140.~~ The lack of education on financial services and *Takāful* literacy makes *Microtakāful* participants susceptible to various types of possible mis-selling and misinformation on the part of MPs. The product literature, contract wording, sales illustration and various other means of information sharing provided by the current TOs are often lengthy and in ~~a an illegible~~ format ~~or, in~~ language that ~~usually requires may not be easily understood careful study on the part of the~~ *Takāful* participant. A potential participant needs to know for certain the types of coverage and exclusions provided by a product plan prior to agreeing to participate in the plan. Furthermore, potential participants must have some understanding of the structure of the product in order for them to be aware of the mechanism for underwriting surplus sharing. However, this may be a challenge for the low-income population, since they may not have the necessary background to understand the intended meaning of the product literature.

~~141.~~ It is important that the RSAs and relevant authorities ensure that the *Microtakāful* participants are protected from their own inability to comprehend the product literature. There should be a requirement to ensure that the product literature of MPs is written in simplified language(s) that is easily comprehensible by the low-income population. The intermediaries appointed by the MPs should also comply with certain codes of conduct to prevent possible types of inappropriate misconduct. ~~.. Additionally, it is important to provide proper training to intermediaries so that their delivery of Microtakāful concepts and products to the target market is clear and concise. This is to boost the confidence level of the target market in the Microtakāful industry.~~

~~137-142.~~ Another important aspect of consumer protection with regards to *Microtakāful* is the user-friendliness of claims settlement. ~~Since the product design of Microtakāful products is generally simpler than that of Takāful products, the claims process for Microtakāful products should also be simpler, without compromising fraud control mechanisms.~~³⁵

~~138-143.~~ Amana *Takāful* of Sri Lanka, in collaboration with Muslim Aid, conducts monthly Centre Meetings for its participants to discuss *Microtakāful*. In these meetings, the *Microtakāful* participants are allocated five to ten minutes to share their experiences of the application and claims process. This is to provide ease of understanding to other participants who may not be aware of the processes for applying and claiming from the MP. It has been reported that during these meetings, key roles are played by village leaders for effective and efficient transfer of information to *Microtakāful* participants, for whom trust seems to be the main concern.

(c) Consumer Recourse and Complaints

due to their financial background. BMT, which started its operations in 1992, has since been a source of financing for small business institutions and provides an alternative to illegal moneylenders.

³⁵ This has been elaborated on at length in paragraphs 43 and 45.

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139. — Many jurisdictions already have in place a dedicated complaint channel for *Takāful* participants. There are ~~dedicated~~ websites, customer services centres, toll-free telephone lines and various other channels that make TOs easily accessible by the participants. ~~However, many of these are not user-friendly for *Microtakāful* participants, since the latest technology for the average-income citizen is still a luxury for the low-income section of the population.~~

140-144. RSAs and the relevant authorities may wish to consider dedicating a complaint channel to *Microtakāful* participants wishing to air their grievances over *Microtakāful*-related issues. This channel should be easily accessible by the participants, at minimal or no cost, to ensure that their welfare is taken care of at all times.

141-145. In India, Uplift Mutuals³⁶ provides a 24/7 helpline to its policyholders. This helpline is managed by medical doctors so as to provide microinsurance policyholders with easy access to medical advices over the phone. Uplift Mutuals also sets up branch offices in rural areas, which provide referral and guidance services so that microinsurance policyholders can collect referral letters to the nearest health service provider. In addition to its helpline, Uplift Mutuals organises monthly health camps, where microinsurance policyholders can receive a preventive check-up on a systematic basis. This is an example of how consumer recourse and complaints can be easily handled by MPs. The 24/7 helpline, the frequent meetings, the easy access to service providers, and the monthly health camps provide avenues for microinsurance policyholders to channel their concerns easily (*Microinsurance Learning and Knowledge*, 2013).

(d) Reporting to RSAs

142-146. It is common for some MPs to offer only *Microtakāful* products with the intention of assisting only the low-income population. This reason has been used to justify why these MPs do not require strict supervision from the RSAs or relevant authorities. However, lack of supervision or reporting is a loophole that can be abused to misuse the pool created to assist the low-income segment. It is hence just as relevant for MPs to be required to adhere to the type of ~~strict~~ reporting that normal TOs are required to follow.

143-147. Instead of requiring the MPs to provide an elaborate report (some jurisdictions may require monthly or quarterly reporting) of the kind required of the TOs, the RSAs and the relevant authorities may request simplified but consequential reporting. This simplified reporting should contain the minimum amount of information needed for the RSAs and relevant authorities to gauge the financial strength of the MP. This is necessary to ensure that MPs have the capacity to undertake their duties and obligations to the participants. It is also necessary for the RSAs and relevant authorities to ensure that financial assistance (*Islamic Financial Services Board, 2010*) is available to assist the *Microtakāful* risk fund when it has difficulty in meeting its obligations. Reporting should be done with the intention to protect the interests of *Microtakāful* participants.

³⁶ "Uplift Mutuals is the flagship programme of Uplift India Association that brings micro insurance solutions to low income families on the twin principles of mutuality-solidarity and collective responsibility. Born out of the health protection needs of self-help group women in 2003, the mutual model designed by Uplift model has over 200,000 lives covered in India. It is one of a kind of a programme where low income families share and manage their own health risk in a systematic way similar to how insurance works." – upliftmutuals.org

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(e) **Application of IAIS' Insurance Core Principles**

~~144-148.~~ Under the IAIS' proportionality principle, ~~the~~ microinsurance providers need ~~still~~ to comply with the requirements set forth under ICP 18: *Intermediaries*, ICP 19: *Conduct of Business* ~~and and~~ ICP 20: *Public Disclosure*, subject to the requirements being ~~implemented in a manner that considers the nature, scale, and complexity of the (business and risks of the) made consistent with the focus of the microinsurance providers.~~ This means that these microinsurance providers should at least have incentives to service the low-income population and be effective in carrying out their tasks. They need to be aware that microinsurance policyholders have different needs in terms of consumer protection than normal insurance policyholders. Their good conduct is pertinent to promote confidence in insurance markets. It is also essential that the type of information shared with the microinsurance policyholders is commensurate with their financial and general literacy.

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~~145-149.~~ From the perspective of supervisory reporting as indicated in ICP 9, there may be a need for additional guidance to be provided by the supervisors with regards to minimum reporting. This is to ascertain minimum understanding by the potentially diverse entities that are involved in the inclusive insurance market innovations.

~~146-150.~~ While the transparency, reporting and market conduct of MPs differs marginally from that of microinsurers, the RSAs of MPs should be mindful of these requirements from the perspective of *Shari'ah* principles. IFSB-9: *Guiding Principles on Conduct of Business for Institutions Offering Islamic Financial Services* provides guidelines on the type of information provided to clients, the concepts of conflict of interest and of duty, and honesty and fairness from the perspective of *Shari'ah*. As quoted in paragraph 4 of IFSB-9, "One of the most common unethical practices in modern business is to exploit one's ignorance of market conditions." This holds true for *Microtakāful* participants, who may not possess the background knowledge of *Takāful* protection and their rights as participants", ~~(IFSB, 2009b) (IFSB, 2009).~~

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IV. **Supervisory Review Process**

(a) **Licensing Requirements**

~~147-151.~~ Licensing is a tool used by RSAs to control entities that are allowed to conduct *Takāful* business. It is a mechanism to ensure that unauthorised *Takāful* transactions do not take place. Through licensing, TOs will be fully aware of the need to have a sound governance framework for ease of effective supervision by RSAs of all their *Takāful* activities.

~~148-152.~~ Although MPs should ideally be required to have a licence prior to being allowed to offer products to the market, it is not always necessarily easy to impose such a requirement since some MPs are not regulated under the RSAs of the *Takāful* sector. For TOs who offer *Microtakāful* products, this poses no issue. However, concerns arise when there are entities which are created exclusively for *Microtakāful* purposes and which may not be regulated by the RSAs or any other regulator of formal entities. Concerns over the sanctity of these unlicensed entities include the effectiveness of their governance framework and the validity of their business model. All entities providing *Microtakāful* plans should meet minimum requirements of having a proper business plan and evidence of sufficient financial resources to

back the business plan. Where the entity does not have the capacity to absorb the risks of *Microtakāful* participants, proof of *ReTakāful* backing should be provided.

149-153. The distribution system of MPs should meet the minimum requirement for conduct of business in which a code of ethics should be observed strictly. The licensing requirement for intermediaries should be considered to be imposed on intermediaries of MPs other than TOs. They should be required to possess appropriate levels of *Takāful* knowledge and expertise, integrity and competence. However, it is worthwhile to note that a requirement that is too stringent will pose a challenge, since many of the *Microtakāful* intermediaries do not enjoy the high remuneration package enjoyed by normal intermediaries. On the other hand, a requirement that is too flexible may put *Microtakāful* participants at risk of not being protected, since the intermediaries are not required to follow the strict licensing rules of the RSAs.

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150-154. In Sri Lanka, for example, the *Regulation of Insurance Industry (RII) Act* requires all MPs to operate under the supervision of a regulatory authority. There are no special regulatory provisions for microinsurance/*Microtakāful* in the jurisdiction. This, in addition to the high administrative costs to register an insurance/*Takāful* business in the jurisdiction, has led to the unwillingness of MPs to acquire a licence to offer just microinsurance/*Microtakāful* products. However, the realisation that the vision of microinsurance/*Microtakāful* extends beyond mere coverage of loan protections has led to implicit deregulation on the part of the RSA. The RSA has taken into consideration the various characteristics of MPs in Sri Lanka, the environment in which they operate, and the target population to whom the microinsurance/*Microtakāful* products are offered. With these in mind, a circular was issued by the Insurance Board of Sri Lanka, which allows the microinsurers/*Microtakāful* operators to appoint MFIs as their institutional agents. Consequently, many MFIs in Sri Lanka have started to become involved in distributing microinsurance/*Microtakāful* products even though they are not permitted by law to conduct insurance/*Takāful* business.

(b) Application of IAIS' Insurance Core Principles

151-155. According to the IAIS' *Application Paper on Regulation and Supervision Supporting Inclusive Insurance Markets*, the overall objective is that informal insurance should be undesirable. Insurance activities should be conducted by licensed entities. Jurisdictions may decide that some limited activities are not included in the definition of regulated insurance activities subject to licensing requirements. When defining regulated insurance activities and exclusions from the licensing requirements, consideration should be given to the need for appropriate alternative safeguards to protect policyholders. Alternative arrangements for microinsurance providers could be as simple as registering the institution (be it a pilot or informal institution with transitional arrangements³⁷) whereby only identification of the institution and its form is registered with the supervisor. These informal institutions will hence report to the supervisor (IAIS, 2012).

152-156. While it may seem practical and simplified, MPs for *Microtakāful* may need to go through a more thorough licensing process due to the need to ensure *Shari'ah* compliance of their operational activities. This translates to the need for MPs to possess adequate resources with sufficient knowledge to facilitate effective and efficient application, processing and granting of *Microtakāful* licence expansion of information about *Microtakāful* products to the participants.

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³⁷ These are institutions that require time to transition to formal entities that will be regulated by the RSAs of insurance companies.

D. PROPOSAL FOR FUTURE WORK

~~153-157.~~ *Microtakāful* is a segment of the financial industry that is rapidly gaining acceptance by financial institutions, and especially by RSAs and government agencies. The realisation that the low-income population should not be excluded from the financial system is gaining ground, since their contribution to the economic system of every jurisdiction, ~~no matter how minimal,~~ warrants providing them the opportunity to enjoy similar kinds of financial services as are available to other income segments. In India, for example, the RSA requires that a minimum target of gross written premium should be written by microinsurance providers, to ensure that the insurance industry contributes to the national initiative on financial inclusion. This is reflected in its “Obligations of Insurers to Rural or Social Sectors”, which took effect on 16 October 2002 and stipulates that insurers which started their operations after 1999 must sell a fixed percentage of their policies to the social sector and rural areas. Progress has shown that as many as 25.7% of new life insurance policies were underwritten and sold in 2012 and 2013. According to the Insurance Regulatory and Development Authority’s 2012 and 2013 annual reports, all 23 private-sector life insurance companies had fulfilled their rural-sector obligations ~~(Insurance Regulatory and Development Authority of India, 2002: Business Standard, 2014).~~ ~~(Insurance Regulatory and Development Authority of India, 2002) (Business Standard, 2014).~~ Another example is Jordan, where the government is planning to revise its Insurance Law 2002 in order to promote microinsurance/*Microtakāful*, specifically in the licensing conditions for intermediaries (GTZ, 2004).

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~~154-158.~~ However, making abrupt changes to the current system in an attempt to render it inclusive requires careful consideration, since this will have an impact not only on the current structure and framework, but also on the way the financial industry is regulated, the way products are developed and sold, the way distribution channels are utilised, and, most importantly, on the way these initiatives are perceived by the public.

~~155-159.~~ *Takāful* is known for its Islamic features, which are free from *Sharī’ah* non-compliant elements. The products and services offered by the TOs carry with them not only a financial, but also a religious, obligation to be fulfilled. There is a similar scenario with *Microtakāful*. The only difference is the need to ensure that the objective of *Microtakāful* is clarified clearly to participants that have different demographic and educational backgrounds.

~~156-160.~~ For *Microtakāful* to achieve its target of inclusivity, a concerted effort needs to be made by all the stakeholders. This paper identifies two important areas as possible directions for future work on *Microtakāful*:

(a) To identify a successful cooperation mechanism between stakeholders (especially between the RSAs, government agencies, TOs, RTOs and ~~SBSharī’ah Board~~), and to understand the roles and responsibilities of each of the stakeholders.

(b) To delineate the specific areas to be looked into by RSAs and relevant authorities when regulating the MPs. These significant areas include MPs’ corporate governance strategy and structure, ~~solvency requirements,~~ underwriting requirements, licensing provisions, fund management framework, ~~consumer protection, use of digital technology~~ and regulatory reporting.

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E. APPENDIX

CASE STUDY: PAKISTAN MICROINSURANCE REGULATORY FRAMEWORK

(Securities and Exchange Commission of Pakistan, 2014)

1. On 20 February 2014, the Policy Board of the Securities & Exchange Commission of Pakistan (SECP) approved the *Securities & Exchange Commission (Microinsurance) Rules 2014* (hereinafter referred to as “the Microinsurance Rules”). The Microinsurance Rules provide standards for conduct of microinsurance business with specific focus on consumer protection, transparency and disclosure requirements. The same aforementioned Rules are applicable to the business activities and operations of **microinsurance provider**MPs operating in Pakistan.
2. In the Microinsurance Rules, the term “Microinsurance” is used interchangeably with “Microtakāful”, “Life Microinsurance” with “Family Microtakāful”, “Non-Life Microinsurance” with “General Microtakāful”, “Premium” with “Contribution”, and “Insurer” with “Operator”. Specific categorization is also made on the type of products that fall under the definition of microinsurance, by which the sum insured may not exceed a certain amount as stipulated in the Microinsurance Rules.
3. The type of guidance provided by the SECP to its microinsurance providers is focused on the key features of a microinsurance policy and they are as follows:
 - (a) **Coverage:** A microinsurance policy shall cover the insured severally or jointly with the insured’s family and/or the insured’s assets.
 - (b) **Period of cover:** The term of the microinsurance policy shall state the period of cover, to be determined by the insurer depending on the type of coverage.
 - (c) **Terms and conditions:** A microinsurance policy shall clearly state the sum insured, benefits and terms of insurance coverage. The manner and frequency of premium collections shall, if possible, coincide with the cash flow of the insured and may be collected daily, weekly, monthly, quarterly, semi-annually, and annually, whichever is applicable.
 - (d) **Effectivity:** Except in cases where a microinsurance policy is issued to a group, a microinsurance policy shall become effective immediately if either the microinsurance policy has been issued by the insurer or seven ~~(07)~~ working days have passed from the date when the first premium has been paid in full by the microinsurance policyholder, whichever is the earliest.
 - (e) **Claims procedures:** A microinsurance policy shall clearly state when, where and how a microinsurance policyholder can make a claim, the documents required to make such claim, the claims process and expected turnaround time for settlement of the claim.
 - (f) **Dispute resolution:** A microinsurance policy shall clearly state when, where and how a microinsurance policyholder can make a complaint. This should state the contact details of

both the insurer as well as the alternative dispute resolution mechanism and the insurance ombudsman.

- (g) **Waiting periods:** A maximum of ~~six~~6 months for death or disability due to natural causes for policyholders not exceeding the age of 65 years. No waiting period shall be allowed for accidental death or accidental disability.
 - (h) **Grace period:** Except health microinsurance and policies where the premium is paid on a frequency other than an annual basis, a 30 days' grace period is allowed for such microinsurance policies. If there is a claim made during such grace period, the outstanding premium shall be deducted from such claim amount.
 - (i) **Exclusions:** All exclusions shall be clearly stated in the microinsurance policy document. Except in cases where a microinsurance policy is not issued to a group, no exclusions shall be allowed for pre-existing conditions unless the insurer can clearly justify otherwise to the Commission.
 - (j) **Deductibles:** No deductibles shall be allowed in microinsurance policies unless the insurer can clearly justify otherwise to the Commission.
 - (k) **Renewals:** For microinsurance policies where the premium is paid on ~~a frequency~~ of an annual basis, the insurer shall send notices to the microinsurance policyholder at least 45 calendar days prior to expiration of the contract. Such notice shall include in clear terms whether the contract may or may not be renewed and any changes to be made thereon, if renewed.
 - (l) **Premium payment:** The microinsurance policy shall clearly state the amount of premiums to be paid with respect to the policy, where and how to pay such premium and the consequences if premiums are not paid.
4. On Consumer Protection, the microinsurance providers are required to be transparent in their disclosure, ~~in which the language used, which must be made,~~ in Urdu language. In all circumstances any technical or legal terminology should be avoided. The microinsurance providers are also required to observe fair practices whereby the services provided should be made in a manner that is legal, ethical, non-discriminatory and free of deception. The microinsurance providers are also required to make themselves easily accessible to the policyholders ~~by~~through telephones, and through internal complaint handling systems. These requirements are equally applicable for all microinsurance providers' intermediaries.
5. On Supervisory Reporting, life microinsurance providers are required to report microinsurance as a separate category of business, and provide the SECP with at least the statement of premiums, statement of claims and statement of direct expenses. For non-life microinsurance providers, the microinsurance providers are required to provide the statement of premiums, statement of claims, statement of direct expenses, analysis of claims as well as risk exposure.

F. DEFINITIONS

The following definitions provide a general understanding of the terms specific to Takaful and Microtakaful used in this document. This list is by no means exhaustive one.

Corporate governance	A defined set of relationships between a company's management, its board of directors, shareholders and other stakeholders that provides the structure through which: (i) the objectives of the company are set; and (ii) the means of attaining those objectives and monitoring performance are determined. In the context of <i>Takaful</i> (TUs) and <i>ReTakaful</i> undertakings (RTUs), good corporate governance should encompass: (i) a set of organisational arrangements whereby the actions of the management of TUs and RTUs are aligned, as far as possible, with the interests of its stakeholders; (ii) provision of proper incentives for the organs of governance such as the board of directors, the <i>Shari'ah</i> Board and management to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging TUs and RTUs to use resources more efficiently; and (iii) compliance with <i>Shari'ah</i> rules and principles.
Liabilities	The financial obligations of both the Shareholders' Fund (SHF) and the Participants' Risk Funds/Participants' Investment Funds (PRFs/PIFs) or <i>Takaful</i> Operators' Risk Funds. Detailed descriptions are set out below: (i) Liabilities of the SHF are all financial obligations of those funds, and do not include technical provisions which are liabilities of the PRFs/PIFs or TORFs. (ii) Liabilities for PRFs/PIFs and TORFs include financial obligations owed by the funds, particularly amounts payable to participants in respect of valid expected benefits. In addition, PRFs' and TORFs' liabilities include technical provisions in respect of potential liabilities from business already written.
<u>Microtakaful Provider</u>	<u>Institutions offering Microtakaful products, including licensed Takaful Operators.</u>
<i>Muḍārabah</i>	A contract between the capital provider and a skilled operator whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the operator as the <i>Muḍārib</i> (or labour provider). Profits generated by the enterprise or activity are shared in accordance with the terms of the <i>Muḍārabah</i> agreement, while losses are to be borne solely by the capital provider unless they are due to the <i>Muḍārib</i>'s misconduct, negligence or breach of contracted terms.
Operational risk	The risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. For <i>Takaful</i> or <i>ReTakaful</i> undertakings, this also includes risk of loss resulting from <i>Shari'ah</i> non-compliance and failure of a <i>Takaful</i> or <i>ReTakaful</i> Operator's fiduciary responsibilities.

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Participants' Risk Fund (PRF)	A fund to which a portion of contributions paid by <i>Takāful</i> participants is allocated for the purpose of meeting claims by <i>Takāful</i> participants on the basis of mutual assistance or protection.
Provisions	(i) The amounts set aside on the balance sheet to meet liabilities arising out of <i>Takāful</i> or <i>Re-Takāful</i> contracts, including claims provision (whether reported or not), provision for unearned contribution, provision for unexpired risks, <i>Takāful</i> or <i>Re-Takāful</i> provision, and other liabilities related to <i>Takāful</i> or <i>Re-Takāful</i> contracts (e.g. contributions, deposits and savings accumulated over the term of <i>Takāful</i> or <i>Re-Takāful</i> contracts). (ii) Terms, conditions or requirements of a contract, agreement, item of regulation or standard.
<i>Qarḍ</i>	A loan without remuneration intended to allow the borrower to use the funds for a period with the understanding that it would be repaid at the end of the period.
<i>ReTakāful</i>	An arrangement whereby a <i>Takāful</i> undertaking (TU), as representative of participants under <i>Takāful</i> contracts, contributes a sum of money as <i>Tabarru'</i> commitment into a common fund maintained by a <i>Re-Takāful</i> undertaking on a <i>Takāful</i> basis (i.e. covering participants of that and other TUs against specified loss or damage).
<i>ReTakāful</i> Operator	Any establishment or entity that manages a <i>Re-Takāful</i> business, usually, though not necessarily, a part of the legal entity in which the participants' interests are held.
Risk management	The process whereby the <i>Takāful</i> or <i>Re-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, as well as its cash flow.
Shareholders' Fund	The part of the assets and liabilities of a <i>Takāful</i> or <i>Re-Takāful</i> undertaking that is not attributable to participants in the form of a Participants' Risk Fund, Participants' Investment Fund or <i>Takāful</i> Operators' Risk Fund.
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> or <i>Re-Takāful</i> undertaking must have in addition to the assets covering its technical provisions and other liabilities.
Stakeholders	Those with a vested interest in the well-being of <i>Takāful</i> (TU) or <i>Re-Takāful</i> (RTU) or <i>Microtakāful</i> undertakings, including: (i) employees; (ii) <i>Takāful</i> participants or cedants under <i>Re-Takāful</i> arrangements; (iii) suppliers; (iv) the community (particularly the Muslim ummah); and (v) supervisors and governments, based on the unique role of TUs and RTUs in national and local economies and financial systems.

<i>Tabarru'</i> commitment	The amount of contribution to be relinquished by the <i>Takāful/ReTakāful</i> participant as a commitment for fulfilling the obligation of mutual help and to be used to pay claims submitted by eligible claimants.
<i>Takāful</i>	The term <i>Takāful</i> is derived from an Arabic word which means solidarity, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks. In a <i>Takāful</i> arrangement, the participants contribute a sum of money as <i>Tabarru'</i> commitment into a common fund, which will be used for mutual assistance of the members against specified loss or damage.
<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 (similar to "policyholder" in conventional insurance).
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: 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 a margin for risk over the current estimate.
Underwriting	The process of evaluating new applications, carried out by a <i>Takāful</i> or <i>ReTakāful</i> Operator on behalf of the <i>Takāful</i> or <i>ReTakāful</i> participants based on an established set of guidelines to determine the risk associated with an applicant. The <i>Takāful</i> or <i>ReTakāful</i> Operator could accept the application, or assign the appropriate rating class, or decline the application on.
Underwriting risk	Underwriting risk is the risk of loss due to underwriting activities relating to the Participants' Risk Fund or <i>Takāful</i> Operators' Risk Fund. Sources of this risk include assumptions used in pricing or assessment that are subsequently shown to be incorrect by experience of, for example, claims.
Underwriting surplus or deficit	The Participants' Risk Fund's or <i>Takāful</i> Operators' Risk Fund's financial result 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 contributions 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.
<i>Waqf</i>	A voluntary, permanent, irrevocable dedication of a portion of one's wealth I in cash or kind I to Allah Almighty. Once a <i>Waqf</i> is established, it can never be gifted, inherited or sold. It belongs to Allah Almighty and the corpus of the <i>Waqf</i> always remains intact. The yield and/or usufruct of the <i>Waqf</i> may be utilised for any <i>Shari'ah</i> compliant purpose as determined by the <i>Waqf</i> deed.

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