



ISLAMIC FINANCIAL SERVICES BOARD

and



**INTERNATIONAL ASSOCIATION OF
INSURANCE SUPERVISORS**

**ISSUES IN
REGULATION AND SUPERVISION OF
TAKAFUL (ISLAMIC INSURANCE)**

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Issues in Regulation and Supervision of Takaful (Islamic Insurance)

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Background

The Islamic Financial Services Board (IFSB) and the Insurance Commission of Jordan co-organised an inaugural seminar on the regulation of Takaful (Islamic Insurance) in Jordan on 10-11 January 2005. The Seminar adopted the following recommendations:

- The IFSB plays an active and complementary role to that of the International Association of Insurance Supervisors (IAIS) by issuing prudential and supervisory standards for Takaful that would safeguard the interests of the consumers and the soundness and the stability of the financial system as a whole;
- Priority in the IFSB work plan for Takaful should be given to specific and immediate regulatory issues that require, as far as reasonably possible, harmonisation across Takaful industry; and
- To this end, the IFSB is encouraged, as an initial step, to establish a joint working group with the IAIS to produce an issues paper on the applicability of the existing IAIS core principles to the regulatory and supervisory standards for Takaful to be developed by the IFSB.

Following the above recommendations, the present Joint Working Group was established and met in Jordan on 10 May and 13 September 2005.

SECTION 1 – BACKGROUND TO TAKAFUL

1. Takaful is the Islamic counterpart of conventional insurance, and exists in both life (or “family”) and general forms. It is based on concepts of mutual solidarity, and a typical Takaful undertaking will consist of a two-tier structure that is a hybrid of a mutual and a commercial form of company. This in itself poses significant issues for regulation and supervision. In addition, all the functions of a Takaful undertaking should conform fully to Islamic law (Shari’a), and this has implications in other areas of regulation and supervision. This section sets out the background.

Islamic Religious Law (Shari’a)

2. To Muslims, Islamic law, called the Shari’a, is divinely revealed law that dictates the way of life for mankind. It is all-embracing and covers not only the practice of religious worship but also how Muslims should live their lives and, by extension, conduct commerce. The authority of the Shari’a is drawn primarily from the Qur’an and the Sunna. The Qur’an is the holy book which Muslims believe contains God’s word as directly revealed to the Prophet Muhammad. The Sunna refers to the spoken advice, acts and tacit approvals of the Prophet Muhammad. Where a new situation arises which requires an interpretation of the law, qualified Shari’a scholars engage in *ijtihad*, which is a method of legal reasoning by analogy from the sources of the law to explore possible solutions to the problem. It may take some time for the scholars to arrive at a consensus, and there is no body that can impose an interpretation, though there are some bodies of scholars whose collective view carries great weight.

Insurance in Islam

3. Islam is not against the concept of insurance itself but against some of the means and methods that are currently used in conventional insurance. In fact, the concept of mitigation of risks by adopting the law of large numbers was widely used in Islam and especially in the practice of “*al-aqilah*” described below. However, to be acceptable to Islam, any form of insurance should avoid the elements of *riba* (interest), *maisir* (gambling) and *gharar* (uncertainty), though elements of *gharar* may be forgivable depending on the circumstances.

The Origins of Takaful

4. The origin of Takaful can be traced to several practices from ancient Arab tribal custom and the companions of the Prophet. For example, under the custom of “*al-aqilah*”, it is mutually agreed among the tribes that if a person is killed unintentionally by a person of a different tribe, the accuser’s paternal relatives will take the responsibility to make a mutual contribution for the purpose of paying the blood money to the victim’s relatives. This practice of having a fund that pools contributions from a group of people to assist others in need was further encouraged in the early Islamic period.

5. The first modern Islamic insurance was introduced in Sudan, and was based on a cooperative model not dissimilar from a conventional mutual insurer. More commercial models of Takaful were later implemented in countries such as Malaysia and Saudi Arabia. Takaful has evolved into a viable alternative to conventional insurance and is able to attract a wide range of customers, Muslim and non-Muslim alike. For example, in Sri Lanka, where less than 10 percent of the population is Muslim, some 15% of the policyholders of the sole Takaful undertaking there are non-Muslims.

6. The development of Takaful is now seen as a key component of the development of Islamic finance in general, not least because of its ability to mobilise funds for investment in a similar way to conventional insurance.

7. Takaful is now practised by over 60 companies in 23 countries and has now evolved into a rapidly growing industry. More recently, *retakaful*, the equivalent of conventional reinsurance, has been developed, initially in Malaysia. At present, most Takaful operators reinsure to conventional reinsurers, and this is considered acceptable so long as there is no practicable Shari’a compliant alternative.

The Takaful Contract

8. Takaful is derived from an Arabic word which means solidarity, whereby a group of participants agree among themselves to support one another jointly against a defined loss. In a Takaful arrangement, the participants contribute a sum of money as wholly or partially *tabarru’* (donation) into a common fund, which will be used mutually to assist the members against a defined loss or damage.

- Currently, Takaful is offered through the following business forms:
- Non-profit, whereby regardless of the formal legal structure, the business is run on a purely mutual or cooperative basis for the participants in the Takaful scheme. The board runs the business on behalf of all participants and there is no separate entity managing the business.
- Commercial, whereby a commercial entity (Takaful operator) is entrusted with managing the Takaful fund. Depending on the specific rules in each jurisdiction, the fund may be embedded within the operator (as life funds commonly are in conventional insurers), with a clear separation between shareholders’ and participants’ funds, or the fund may be set up as a company separate from the operator. In some countries a Takaful scheme may be offered through a “window” of a conventional insurer. In Family (Life) Takaful, the participant’s contribution is typically divided into two portions, one forming part of the Takaful pool to cover mortality risk, and the other in effect constituting a personal investment account (as a sub-account of the investment fund).

9. There are several forms of contract that govern the relationship between the participants (policyholders) and the Takaful operator. The most widely used contracts are the *mudaraba* (profit-sharing) contract and *wakala* (agency) contract.

- **Pure Mudaraba Model:** In a *mudaraba* model, the Takaful operator acts as a *mudarib* (entrepreneur) and the participants as *rab ul mal* (capital provider). The contract specifies how the investment profit and/or surplus from the Takaful operation

are to be shared between the Takaful operator and participants. Losses are borne solely by the participants as the providers of capital on the condition that the operator is free from any misconduct and negligence actions, and in that case the *mudarib* is not entitled to receive any compensation for his efforts.

- **Pure Wakala Model:** under this model, the principal-agent relationship is used for both underwriting and investment activities. In underwriting, the Takaful operator acts as an agent on behalf of the participants to run the Takaful fund. All risks are borne by the fund and any operating surplus belongs exclusively to the participants. The Takaful operator does not share directly in either the risk borne by the fund or any surplus/deficit of the fund. Instead, the operator receives a set fee called a *wakala* fee for managing the operation on the participants' behalf, which is usually a percentage of contributions paid. However, the operator's remuneration may include a performance fee, charged against any surplus, as an incentive to manage the Takaful fund effectively. The investment of the Takaful fund is also based on a *wakala* contract whereby the operator charges the participants a fee in exchange for services rendered.
- **Combination of wakala and mudaraba contracts:** In this model, the *wakala* contract is adopted for underwriting activities, while the *mudaraba* contract is employed for the investment activities of the Takaful fund. This approach appears to be favoured by some international organisations and is widely adopted by Takaful undertakings in practice.

In all models the Takaful operator will usually provide an interest-free loan to cover any deficiency in the Takaful fund. The loan has to be repaid from any future surpluses of the Takaful fund.

Comparison between Takaful and conventional insurance (proprietary and mutual) – general insurance

	Conventional Insurance (Proprietary)	Conventional Insurance (Mutual)	Takaful
Contract	• A policy in the form of an exchange contract (sale and purchase) between the insured (policyholder) and the insurance company.	• A policy in the form of a risk sharing contract between the individual insured and the pool of insureds as represented by the cooperative insurance company.	• A combination of <i>tabarru'</i> contract (donation) and agency and/or profit sharing contract between the individual insured and the pool of insureds as represented by the Takaful.
Responsibility of policyholders/ participants	• Policyholders pay premium to the insurer.	• Policyholders pay contributions to the pool in the form of premiums paid to the cooperative insurance company. • Any underwriting surplus belongs to the policyholders, who are also liable for any deficit.	• Participants make contributions to the scheme. • Any underwriting surplus belongs to the policyholders, who are also liable for any deficit. Practices regarding disposition of annual

	Conventional Insurance (Proprietary)	Conventional Insurance (Mutual)	Takaful
		Annual surpluses are normally retained in underwriting reserves out of which any annual deficits are normally met.	underwriting surpluses or deficits vary. In some Takaful, operator manages underwriting under a Mudaraba contract and shares in underwriting surplus as a Mudarib fee.
Liability of the insurer/operator	Insurer is liable to pay claims according to the policy using the underwriting fund and, if necessary, shareholders' funds.	Pool is liable to pay claims according to the policy using the underwriting fund.	- Takaful operator acts as the administrator of the scheme and pays the Takaful benefits from the Takaful (underwriting) fund. - In the event of deficiency in the Takaful fund, the Takaful operator is expected to provide an interest-free loan to the Takaful fund to cover the deficiency.
Access to capital	Access to share capital and debt with possible use of subordinated debt.	No access to share capital, but access to debt with possible use of subordinated debt.	Access to share capital by Takaful operator but not to debt, except for interest-free loan from operator to underwriting fund.
Investment of Fund	There are no restrictions apart from those imposed for prudential reasons.	There are no restrictions apart from those imposed for prudential reasons.	Assets of the Takaful funds are invested in Shari'a-compliant instruments.

A similar comparison may be made between conventional insurance and Takaful in the case of Life Insurance. In the latter case, in both conventional mutuals and Takaful, investment profits belong to the policyholders, except that in Takaful the operator may share in these profits as a Mudarib fee for fund management. There are also some products (such as 'Whole Life' cover and 'Defined Benefit' pensions) which Takaful does not offer as they are not Shari'a compliant.

Some of the implications of these differences will be drawn out in the next section.

SECTION 2 – APPLICATIONS OF IAIS CORE PRINCIPLES

Regulatory issues in Takaful

10. The differences between Takaful and conventional insurance clearly have regulatory implications. For example:

- A Takaful operator has an obligation to ensure that all aspects of the insurance operations are compliant with Shari'a rules and principles. To do so, it will draw on in-house religious advisers, commonly known as a Shari'a board.
- The Takaful operator will be representing to policyholders, either explicitly or implicitly, that its operations are in accordance with Shari'a rules and principles. Some regulators would consider they had a responsibility to ensure that such representations are well-founded.
- In a Family Takaful plan there are generally no guarantees (i.e. they operate on a 'defined contribution' rather than a 'defined benefit' basis). This implies that the risk profile is different from the standard insurance product, where guarantees are normally given in terms of maturity benefits, surrender benefits and death benefits. This has implications both for capital adequacy and for disclosure to consumers.
- The solvency regime needs to reflect the location of risk. For example, if there is a deficit in the underwriting fund, how strong is the obligation on the operator to give an interest-free benevolent loan, and what account should be taken of this in the solvency regime. This raises the issue in practice of whether liability can be extended to policyholders' investment accounts.
- Because policyholders share in any surpluses and, in principle, meet any deficits in the underwriting pool, there is a need to determine how their shares should be determined. At present different companies follow different policies in this respect.
- Because investments must be Shari'a compliant, a Takaful firm cannot invest in conventional interest-paying bonds, or in certain types of equity (brewers being an obvious example). There are also limitations on the use of derivatives, for example to hedge currency risk. The asset risk profile will therefore be different from that of a conventional insurer.

These are only examples, but they should be sufficient to indicate that regulatory regimes developed for conventional insurance cannot necessarily be applied uncritically to Takaful.

11. There is thus a need to develop standards and interpretations:

- To provide benchmarks for use by Takaful supervisors in all jurisdictions adapting and improving existing regulatory regimes or, where necessary, establishing new ones.
- To address regulatory issues, such as risk management and financial stability, for the Takaful industry.
- To provide appropriate levels of consumer protection in terms of both risk and disclosure.
- To support the orderly development of the Takaful industry in terms of acceptable business and operational models, design and marketing of Takaful products.

The IAIS Insurance Core Principles

12. A sound regulatory and supervisory system is necessary for maintaining efficient, safe, fair and stable insurance markets and for promoting growth and competition in the sector. Such markets benefit and protect policyholders. The IAIS Insurance core principles (ICPs) provide a globally accepted framework for the regulation and supervision of the insurance sector. They provide the basis for evaluating insurance legislation, and supervisory

systems and procedures, and are used for that purpose by the IMF and the World Bank. They apply to the supervision of insurers and reinsurers, whether private undertakings or government-controlled insurers that compete with private enterprises, wherever their business is conducted. They have therefore formed the basis of our work.

13. The approach followed in preparing this paper has therefore been to consider each ICP, including the essential criteria (ECs) and advanced criteria (ACs) set out in the Insurance Core Principles and Methodology of October 2003, and with the benefit of the explanatory text. (Where the ICPs are quoted in this document, in the interests of space they are quoted only at Principle level, and reference should be made to the underlying document to follow the detail of the discussion.)

14. This is a preliminary analysis to identify possible issues which the IFSB may wish to address and not a set of proposals for current amendment of the ICPs.

Principles universally applicable

15. Some of the ICPs are general principles which are universally applicable and appear to require no adaptation to apply to Takaful. These are ICPs 2, 4, 5, 8, 11, 12, 13, 14, 15, 17, 18, 20, 27 and 28.

ICP 2: Supervisory Objectives

The principal objectives of insurance supervision are clearly defined.

ICP 4: Supervisory Process

The supervisory authority conducts its functions in a transparent and accountable manner.

ICP 5: Supervisory Cooperation and Information Sharing

The supervisory authority cooperates and shares information with other relevant supervisors subject to confidentiality requirements.

ICP 8: Changes in Control and Portfolio Transfers

The supervisory authority approves or rejects proposals to acquire significant ownership or any other interest in an insurer that results in that person, directly or indirectly, alone or with an associate, exercising control over an insurer.

The supervisory authority approves the portfolio transfer or merger of insurance business.

ICP 11: Market Analysis

Making use of all available sources, the supervisory authority monitors and analyses all factors that may have an impact on insurance markets. It draws conclusions and takes action as appropriate.

ICP 12: Reporting to Supervisors and off-site Monitoring

The supervisory authority receives necessary information to conduct effective off-

site monitoring and to evaluate the condition of each insurer as well as the insurance market.

ICP 13: On-site Inspection

The supervisory authority carries out on-site inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements.

ICP 14: Preventive and Corrective Measures

The supervisory authority takes preventive and corrective measures that are timely, suitable and necessary to achieve the objectives of insurance supervision.

ICP 15: Enforcement or Sanctions

The supervisory authority enforces corrective action and, where needed, imposes sanctions based on clear and objective criteria that are publicly disclosed.

ICP 17: Group-wide Supervision

The supervisory authority supervises its insurers on both a single entity and a group-wide basis.

ICP 18: Risk Assessment and Management

The supervisory authority requires insurers to recognise the range of risks that they face and to assess and manage them effectively.

ICP 20: Liabilities

The supervisory authority requires insurers to comply with standards for establishing adequate technical provisions and other liabilities, and making allowance for reinsurance recoverable. The supervisory authority has both the authority and the ability to assess the adequacy of the technical provisions and to require that these provisions be increased, if necessary.

ICP 27: Fraud

The supervisory authority requires that insurers and intermediaries take the necessary measures to prevent, detect and remedy insurance fraud.

ICP 28: Anti-money Laundering, Combating the Financing of Terrorism (AML/CFT)

The supervisory authority requires insurers and intermediaries, at a minimum those insurers and intermediaries offering life insurance products or other investment related insurance, to take effective measures to deter, detect and report money laundering and the financing of terrorism consistent with the recommendations of the financial action task force on money laundering.

Principles that may require further study

16. Although this part may be subject to further study, some of the ICPs do appear to require some adaptation, or at least interpretation, to cater fully for Takaful. In most instances, this is at the criterion level, rather than in the Principle itself. These Principles, and the issues identified, are as follows:

ICP 1: Conditions for Effective Insurance Supervision

Insurance supervision relies upon:

- A policy, institutional and legal framework for financial sector supervision;
- A well developed and effective financial market infrastructure; and
- Efficient financial markets.

17. For Takaful, a part of the financial market infrastructure is the development of effective Shari'a oversight, which implies the existence of an adequate pool of qualified scholars. In addition, it should be noted that the existence of an adequate legal framework for dealing with conventional insurance issues does not necessarily imply that it will be equally competent to deal with Takaful contracts. Similarly, financial markets in Islamic instruments are frequently less developed than those for conventional instruments.

ICP3: Supervisory Authority

The supervisory authority:

- has adequate powers, legal protection and financial resources to exercise its functions and powers;
- is operationally independent and accountable in the exercise of its functions and powers;
- hires, trains and maintains sufficient staff with high professional standards; and treats confidential information appropriately.

18. It is observed that regulators differ in how they see their role in relation to Shari'a compliance. Some have established their own Shari'a board either to advise on Takaful-specific rules or to oversee the operation of Takaful companies' Shari'a boards. Others have not done so, and have either stood apart from Shari'a issues entirely or have seen their role only as ensuring that Takaful companies have established appropriate Shari'a boards and have followed their advice. There is as yet no consensus on the role of the regulator in this area; in essence the debate is whether the regulator should be a "Shari'a regulator" or a "Shari'a systems regulator", or neither.

ICP 6: Licensing

An insurer must be licensed before it can operate within a jurisdiction. The requirements for licensing are clear, objective and public.

19. The licensing requirement must be able to accommodate forms of operational structure appropriate to Takaful, and may restrict those that are permissible. In particular, the jurisdiction must clearly determine whether Takaful business may be carried on either as a fully-fledged company or through a 'Takaful window' of a conventional insurer, or both.

20. It is also necessary to have guidance on how the requirement that the business be conducted in accordance with Shari'a is to be reflected in the licensing requirements. By one means or another, those businesses that purport to be Islamic must be distinguished from those that do not, and any business in the former category must be required to have a Shari'a committee or advisor to ensure that its business does not involve any element that is not approved by Shari'a.

ICP 7: Suitability of Persons

The significant owners, board members, senior management, auditors, and actuaries of an insurer are fit and proper to fulfil their roles. This requires that they possess the appropriate integrity, competency, experience and qualifications.

21. Consideration should probably be given to extending this Principle to members of the company's Shari'a board, although this will depend on the view taken of the issue raised in relation to ICP 3. The Shari'a board would then be part of the governance structure of the Takaful company and its members regarded as key functionaries who are subject to the requirements and assessment with respect to their 'fitness and propriety' mentioned in EC a.

22. EC f states that the supervisory authority should disallow certain functionaries from simultaneously holding two positions in an insurer where this could result in a material conflict of interest. To the extent that the supervisory authority takes an interest in the membership of the Shari'a board, a similar approach may be relevant.

ICP 9: Corporate Governance

The corporate governance framework recognises and protects rights of all interested parties. The supervisory authority requires compliance with all applicable corporate governance standards.

23. For a Takaful undertaking corporate governance would extend to the Shari'a board. In this regard there are relevant international standards which can be referenced for the appointment, composition and report of the Shari'a board. Consideration also needs to be given to the relationship between the Shari'a board and other governance structures of the company, to ensure that responsibilities are clearly and appropriately allocated.

24. There is a potential for conflicts of interest if members of the Shari'a board are significant shareholders in the Takaful operator or hold Board or senior management positions. Given the limited number of Shari'a scholars competent in the field, there is also a possibility that they may hold shares or management roles (including Shari'a board membership) in the firm's counterparties or competitors. If this is not prohibited (see ICP 7) then rules must be put into place to require appropriate management of any conflicts of interest.

25. In addition, because the interests of policyholders may diverge from those of the shareholders of the Takaful operator, whose board of directors is in principle acting on behalf of both groups but which is appointed only by the shareholders, there is reason to consider whether policyholder interests need to be represented within the governance structure. Such representation might, for example, extend to any committees established to decide on investment policy, since there may be issues around which investments are attributed to shareholders' funds and which to policyholders' funds.

ICP 10: Internal Control

The supervisory authority requires insurers to have in place internal controls that are adequate for the nature and scale of the business. The oversight and reporting

systems allow the board and management to monitor and control the operations.

26. For a Takaful undertaking, consideration should be given to including Shari'a controls as well. Whereas an internal auditor would ensure that all statutory regulations and guidelines are being followed, the same must be done for all aspects of the insurance business where the Shari'a board has given a ruling. A Shari'a audit would be a normal part of the expected regime.

ICP 16: Winding up and Exit from the Market

The legal and regulatory framework defines a range of options for the orderly exit of insurers from the marketplace. It defines insolvency and establishes the criteria and procedure for dealing with insolvency. In the event of winding-up proceedings, the legal framework gives priority to the protection of policyholders.

27. The insolvency and winding up framework needs to take account of the typical structure of a Takaful operator (with one or more policyholders' pools within the legal entity) and ensure that policyholders' interests are properly protected. In some circumstances this might extend to establishing how far the policyholders in one pool should be liable for any deficit in another.

ICP 19: Insurance Activity

Since insurance is a risk taking activity, the supervisory authority requires insurers to evaluate and manage the risks they underwrite, in particular through reinsurance, and to have the tools to establish adequate levels of premiums.

28. In the case of a Takaful undertaking there is a particular need for systems to control expenses, especially claims handling expenses which are normally charged to Takaful funds, regardless of the Takaful model adopted. In the case of expenses related to contributions, the amount is typically capped at a percentage under the *wakala* model or borne by shareholders under the pure *mudaraba* model. However, the need to control expenses remains relevant given the potential impact on adequacy of shareholders' working capital.

ICP 21: Investments

The supervisory authority requires insurers to comply with standards on investment activities. These standards include requirements on investment policy, asset mix, valuation, diversification, asset-liability matching and risk management.

29. For a Takaful undertaking the Shari'a board plays a key role in setting standards for the types of assets in which the Takaful operator can invest, and standards for choice of assets within an asset class. These standards are in addition to regulations or guidance from the regulators.

30. There are numerous areas where regulatory standards may need to be different for Takaful, or to which supervisors will need to pay special attention. The requirements on the management of investments (EC a) will need to cover the Shari'a compliant assets in which Takaful operators may invest, and there will need to be acceptable ways of valuing them (EC b). There may be issues in the overall risk profile of the assets, for the reasons discussed above, and the limited scope and depth of Islamic financial markets mean that there may also be difficulties in matching assets and liabilities, for example in duration or location.

31. Beyond this, the essentially hybrid nature of a Takaful undertaking means that it will be investing both shareholders' and policyholders' funds. Some governance aspects of this

have been touched on under ICP 9. But there are also systems and controls issues, including a need for clearly defined investment policies for both sets of funds and controls to ensure adherence to these policies and proper management of any conflicts of interest. These issues are relevant in particular to EC a and EC c.

ICP 22: Derivatives and Similar Commitments

The supervisory authority requires insurers to comply with standards on the use of derivatives and similar commitments. These standards address restrictions in their use and disclosure requirements, as well as internal controls and monitoring of the related positions.

32. Again, the Shari'a board would need to give approval or authority to employ any such derivative instruments, with this approval being in addition to any statutory regulations or guidance.

ICP 23: Capital Adequacy and Solvency

The supervisory authority requires insurers to comply with the prescribed solvency regime. This regime includes capital adequacy requirements and requires suitable forms of capital that enable the insurer to absorb significant unforeseen losses.

33. This is a key area in which differences between a Takaful and a conventional company need to be considered.

34. First, the regime needs to take account of the conceptual separation between policyholders' and shareholders' funds. The location of charges/fees and of the corresponding costs and risks varies between operators, and sometimes within each operator by product type or fund. In particular, the extent to which shareholders are committed to supporting any deficit in policyholders' funds through an interest free loan may vary, and this will affect the extent and manner in which shareholders' funds are treated in the solvency regime.

35. The asset profile of a Takaful operator, whether General or Family Takaful, is likely to be very different from its conventional counterpart, and the capital regime needs to take this into account, particularly where the risks are not fully transferred to policyholders (as they are in some investment products). This will be a particular issue for regimes like the current EU standard, which in general treat assets as either inadmissible or fully admissible, but even risk-based capital regimes need to be able to apply appropriate risk weights to Islamic instruments. The limited range of assets available may also make it difficult to avoid concentration risk. Work on the treatment of Islamic instruments from a risk weighting standpoint has already been undertaken by the IFSB in the context of Islamic banking, and this may well prove valuable in the Takaful context.

36. Reinsurance assets may also need consideration, either within the regime or by supervisors, since the pressure to use retakaful companies needs to be balanced against the quality of the security.

37. Again, solvency control levels (EC g) need to be explicit on the relationship between shareholders' and policyholders' funds.

38. It is difficult to be comprehensive in a paper of this kind. In general it is necessary to conduct a detailed review of the specific capital regime under consideration, in the light of the specific structure of a particular Takaful operator in order to determine if any modification is required.

ICP 24: Intermediaries

The supervisory authority sets requirements, directly or through the supervision of insurers, for the conduct of intermediaries.

39. An essential area that needs consideration in regard to intermediaries is the risk of mis-selling. The transparency and behavioural issues are covered under the following Principles, but there will also be competence issues (EC a); intermediaries need to have a sufficient level of knowledge of Shari'a issues and their implications for Takaful, in order to provide effective guidance for potential participants. The discussion under ICP 25 identifies some of the disclosures that may need to be made to consumers, and intermediaries will need to have the competence to make these disclosures and to explain their significance for consumers.

ICP 25: Consumer Protection

The supervisory authority sets minimum requirements for insurers and intermediaries in dealing with consumers in its jurisdiction, including foreign insurers selling products on a cross-border basis. The requirements include provision of timely, complete and relevant information to consumers both before a contract is entered into through to the point at which all obligations under a contract have been fulfilled.

40. For a Takaful operator this would extend to the Shari'a aspects of what is and is not covered under the policy, what guarantees or lack thereof are included, and what liabilities may fall on policyholders. They may also cover the costs or charges that may fall on the policyholders' funds, which are not obvious. Because of the need to avoid uncertainty (*gharar*), for a Takaful operator, transparency is of utmost importance and Shari'a boards will often mandate explicit inclusion of many of these points in the contract. There may nevertheless be a need to explain them to consumers, and to bring out the key differences between Takaful and conventional insurance.

41. There will also be a need to ensure that insurers do not falsely hold themselves out as Takaful firms, or their products as Shari'a compliant either explicitly or implicitly, for example by using names with Islamic overtones. There is, however, no consensus between jurisdictions as to how far it is the supervisor's role to monitor misrepresentations, even in the conventional market.

ICP 26: Information, Disclosure and Transparency towards the Market

The supervisory authority requires insurers to disclose relevant information on a timely basis in order to give stakeholders a clear view of their business activities and financial position and to facilitate the understanding of the risks to which they are exposed.

42. The precise detail of the financial disclosures for a Takaful firm will need to reflect the features of its structure and business as already discussed. In addition, the governance disclosures (EC b) should include information on Shari'a governance arrangements.

SECTION 3 - PROPOSAL FOR FUTURE WORK

43. The issues identified in this paper can be grouped under four major themes:

- Corporate governance
- Financial and prudential regulation
- Transparency, reporting and market conduct
- Supervisory review process

These areas are critical to the regulatory and supervisory framework of the Takaful industry and need to be addressed in an integrated way. The outcomes may then lead to adaptation of the ICP for the Takaful industry by the IFSB, and also to specific guidance in the form of standards.

Corporate governance embraces issues such as the Takaful models that are acceptable and the essential criteria or parameters for each model, the relationship between policyholders' and shareholders' funds, Shari'a governance, and how policyholders' and shareholders' interests are to be balanced in the governance model. These are substantial regulatory and supervisory issues in their own right, but their resolution is also fundamental to making an effective start in the other three areas. For example, it is unclear how to adapt capital adequacy principles for Takaful without having a clear view of the financial risks and where those are located. This in turn is strongly influenced by the model chosen (see paragraph 9 above), and the relationship between shareholders' and policyholders' funds. Similarly, some of the disclosures to participants will depend heavily on the details of the model chosen. This does not imply that there will necessarily be a single model for Takaful, any more than there is in the conventional insurance world. However, if basic principles can be established, it will be much easier to make progress in the other areas. In this regard, the IFSB may seek technical assistance from the IAIS as and when the IFSB deems appropriate.

45. For the reasons given above, it is proposed that priority in further work in adapting the ICPs and in developing prudential standards and guidelines for Takaful should be given to the area of Corporate Governance.