

## **Should countries follow the Malaysia approach of having specific Takaful Act for regulating Takaful business?**

Zainal Abidin Mohd Kassim, FIA

### **Introduction**

In this paper I have first set out to briefly describe the practice of conventional insurance and Takaful so as to provide a contrast in their approach. I have then summarised the role of the Regulator and explained how Takaful is regulated in Malaysia. My reply to the question posed by the title to this paper is set out at the end of this paper.

### **The business of Insurance**

The business of Insurance can be likened to that of a specialist ‘pool’ organiser who would administer a pool of insured. His job is to select the pool members who would pay an appropriate premium. From this premium the organiser would then pay valid claims. Unlike other businesses though insurance can be seen to be different in the following aspects:

- i) The insurer receives remuneration for services in advance (i.e. the premiums) before having to pay out any benefits in respect of claims. As premium need to be invested before claims are paid, the insurer is subject to risks of investment failure.
- ii) In addition to being subject to *speculative risk*, this business is also subject to *pure risk*. Speculative risk is defined as a risk, the happening of which could result in a profit or a loss. Pure risk on the other hand would define an event where possible harm is the only alternative.

The insured who claims only when a loss befalls him, is subject to pure risk. While the pool organiser who gains when the premiums collected plus investment thereon exceeds the claims or makes a loss when premiums collected plus investment thereon is less than the claims incurred is subject to speculative risk.

In this respect in insurance, the insurer’s capital and reserves are held at (speculative) risk to ensure that all claims are paid.

## **The business of Takaful**

Conventional insurance was declared 'haram' due to the existence of al Maisir, al Riba and al Gharar in its operation. Takaful models have therefore been designed to either avoid these traits altogether or to at least minimise them where it is unavoidable.

The Takaful organiser (Operator)'s role is to facilitate the gathering of Takaful participants. The participants are expected to pay a 'contribution' into a Takaful pool towards the Risk covered. On the happening of this risk the participant is allowed to draw from the pool the agreed sum covered. This sum covered would represent the monetary value of the loss he has incurred. The insured is not expected to benefit from this drawdown more than to the extent of the monetary equivalent of his loss.

The agreement between the Takaful Operator and the participant and that between the participants themselves defines the (Islamic) Takaful Contract. Like other Islamic commercial contracts, it is imperative that the role of each party in this contract is clearly defined and avoids elements which in Islam would make the contract haram.

## **The role of the Regulator**

There are many similar risks in Insurance and Takaful which are of concern to the Regulators. The Regulator's primary role is to ensure the soundness of the insurance/takaful markets and the protection of policyholders/participants. Given the size of the insurance markets in some economies, problems of the insurance industry would affect the stability of the underlying economies.

Appendix 1 to this paper sets out the 'Twenty Guidelines for Insurance Regulation and Supervision in Emerging Economies' which is expounded by the Organization for Economic Co-operation and Development (OECD) for developing countries. This can also serve as a guideline for the development of Takaful Regulations in Islamic Countries.

## **Takaful Regulation in Malaysia**

The conduct of Takaful Operation in Malaysia is governed by essentially four 'pillars'. These pillars are:

- i) The Takaful Act of 1984 (the Act) enacted by Parliament (the highest law making body in Malaysia) and various Takaful Regulations issued pursuant to this Act. The Act defines Takaful and restricts the practice of Takaful in the country to those entities which are licensed under the Act. In Appendix 2 there is set out selected excerpts of the Act which defines the conduct of Takaful in Malaysia.
- ii) Various 'guidelines' issued by Bank Negara (the Takaful Regulator) on operational matters and periodic site inspection on the Takaful Operator by the Regulator.
- iii) The Operator's Shariah Council, in ensuring that its operation does not contravene Islamic law.

- iv) The Operator's Auditors and Appointed Actuary. The former in ensuring that the various accounting standards are adhered to, while the latter to report on the continuing ability of the Operator to manage its 'pool' of participants.

## **Practical Issues**

The Takaful Act 1984 was engineered to mirror the conventional insurance Act where possible but to also be general enough to accommodate the newly introduced Takaful Industry. For over ten years since its enactment there was only one Takaful Operator in Malaysia. Now, there are four. In contrast there are sixteen conventional life insurance companies and thirty six general insurance companies operating in Malaysia.

This then underlines the issue, while the conventional insurers in Malaysian can be considered 'developed', its takaful counterparts were new. Being new, they present different challenges. Should Takaful companies be subject to the same level of supervision accorded to conventional companies? Should they be subject to the same capital and solvency requirement?

The Takaful Act and Regulation does not set out the capital and solvency requirement. What should be the basis of these requirements? Should these requirements vary between Takaful Operators which run different Takaful Models? Clearly the many unanswered questions would require the Regulator to weigh the consequences of its Regulatory framework carefully, as this should:

- i) Support the development of Takaful. Takaful, like insurance, is a numbers 'game'. In order to be successful the operation has to quickly reach a certain critical size (so as to benefit from economies of scale) in terms of the number of participants and total funds under investment. Furthermore, in the case of Takaful the Takaful Industry as a whole has to attain critical mass so as to be able to compete with its conventional counterparts.
- ii) Ensure that Takaful participants (policyholders) are given the same level of protection as conventional policyholders.
- iii) Encourage investment in the Takaful industry. This requires a balance in its regulatory policies so that while it protects Takaful participants it does not present a high barrier to entry for new Takaful investors.

## **Malaysia's Experience**

Malaysia's experience in Takaful has been an eventful one. According to the latest available statistics. Takaful funds constitute 5.2% of the total funds in the Takaful and Insurance market. Takaful has come to be accepted by the Muslims in Malaysia as a viable alternative to conventional insurance.

Takaful funds have also contributed to the growth of a dynamic Islamic Capital Market. While the Islamic banks are primarily focused with providing short term capital to businesses, we foresee that Takaful funds have an important part to play in the development of the long term Islamic Capital Market.

The journey has not ended, Malaysia is still experimenting with Takaful. Currently, it is embarking on a review of its Takaful regulation process. When at the start there was only one Takaful Operator, now it has four with each Operator running a slightly different Takaful Model.

Although the Capital and Solvency requirement for Takaful Operators is less stringent than that for conventional companies, the minimum capital requirement for Takaful is RM30 million as opposed to RM100 million for Insurance, the process of monitoring Takaful Operators is by no means lax. The need for capital should be considered from the context of the risks involved. The risks associated with Takaful are different than for conventional insurers, for example:

- i) The investment risk is lower for Takaful Operators as by and large the investment risk is carried by the participants.
- ii) The mortality and morbidity risk is also lower for the Takaful Operator where the Takaful Operator passes most if not all of this risk back to the participants and the re-Takaful operator.
- iii) The operational risk for the Takaful Operator may be higher than for conventional insurers as when most risks are borne by the participants the Operator may have less to lose in any failure.

Given the different risks, the emphasis in the regulation of Takaful would need to be different to that of conventional insurance. As an example, 'on-site' inspection by the Regulators plays an important part in regulating the Takaful Operator.

## **Should there be a different set of regulations for Takaful?**

Ideally yes, for the reasons explained above. This option would not be possible where Muslims do not constitute the majority in a country. Where they are a minority, the ability of Takaful to operate and prosper requires a Takaful Model that can operate and compete with conventional insurers with the same set of rules. Obviously, there will be limits as to where the same set of rules can apply as if it were not so, then conventional insurance would not have been considered haram by the Shariah.

**Islamic Insurance (Takaful): Promoting New Financial Opportunities**  
**Hilton London Metropole 26<sup>th</sup> – 27<sup>th</sup> September 2003**

**Mercer Zainal Consulting Sdn. Bhd.**  
**Suite 17.02 Kenanga International,**  
**Jalan Sultan Ismail,**  
**50250 Kuala Lumpur, Malaysia**  
[zainal.kassim@mercer.com](mailto:zainal.kassim@mercer.com)

**TWENTY INSURANCE GUIDELINES FOR INSURANCE REGULATION AND SUPERVISION IN EMERGING ECONOMIES**

RULE N°1 Adequate prudential and regulatory provision should be enforced in order to ensure the soundness of the insurance markets, the protection of the consumers and the stability of the economy as a whole. Over-regulation should be avoided. The insurance regulatory framework must be adapted to the characteristic of individual countries and encourage the stability, whilst maintaining the necessary flexibility to meet developments in the market.

RULE N°2 Sufficiently strict licensing criteria should govern the establishment of insurance companies. Among these criteria, the testing of the nature and adequacy of the financial resources of insurance companies, in particular through analysis of business plan and the requirement for a relevant minimum level of capital (taking account of inflation) deserves particular consideration. Other key requirements are related to the assessment of the ability of the company to meet legal, accounting and technical requirements and last but not least requirements for a competent management (fit and proper provisions).

RULE N°3 The underwriting of insurance risk should be restricted to insurance companies, which may transact insurance (and connected) operations only. Life and non-life activities should be separated (in distinct companies), so that one activity cannot be required to support the other. The distribution of insurance product by entities from other sectors may be authorised. Risk associated with the activities and structure of financial conglomerates should be adequately monitored.

RULE N°4 Establishment of foreign insurance companies should be based on prudential but non discriminatory rules. Liberalisation of cross-border operations, at least concerning reinsurance and international risks, should be encouraged.

RULE N°5 Adequate insurance contract laws should be established. Rules governing contractual rights and obligations as well as related sanctions, are essential for the protection of both contractual and third parties and indispensable for the development of legal stability. In the absence of contract laws, the approval of policy conditions by the supervisory authority may prove all the more necessary.

RULE N°6 Due to the crucial economic and social role of insurance in the development of an economy, consideration should be given to tax facilities in the life-insurance and pensions filed in the economies in transition.

RULE N°7 The establishment of a supervisory body is essential. The supervisors should be professionally independent and properly trained and impartial. The supervisory body should have sufficient personnel and financial resources as well as adequate powers (including sanctions) to carry out its tasks.

RULE N°8 The examination of records and on site inspections of insurance companies are at the core of the work of the supervisor. An adequate reporting system is essential to achieve this task properly. The secrecy of information communication to and between supervisors should be safeguarded.

RULE N°9 Monitoring solvency margins and capital ratios constitute a key element of dynamic supervision. But adequate tarification and prudent technical provisions backed by reliable and equivalent assets remain the fundamental requirements for maintaining solvency. Adequate business management and reinsurance activities are also indispensable to safeguard the soundness of the companies.

RULE N°10 Initially at least, it may be advisable for economies in transition to request the submission of premium rates and insurance products for prior approval. Supervision of tariffs and products should however be adapted to the particular situation of each country and reassessed at a later stage according to the development and progress of the market.

RULE N°11 Supervisory authorities should take adequate, effective and prompt measures to prevent insurance companies from defaulting, and to arrange an orderly run-off or the transfer of portfolio to a sound company. Appropriate winding-up procedures should be enforced. Under certain conditions, and particularly if the national market comprises a sufficient number of potential contributors with a broad spread of risks, the creation of a compensation fund could be considered.

RULE N°12 Standardised accounting rules are essential to ensure the transparency and comparability of the financial situation of insurance companies. Adequate insurance accounting rules and requirements of reporting and disclosure have to be set as a priority action. The compilation of statistical data regarding the frequency and severity of losses is an essential condition for computing tariffs and technical provisions accurately. Tariffs should be based on statistical data. Actuarial techniques are a key component of insurance management; the role of the actuarial profession could be encouraged.

RULE N°13 Investment regulation should ensure that both security and profitability requirements are respected. It should promote the diversification, spread and liquidity of investment portfolios as well as the maturity and currency matching of assets and liabilities, although some temporary dispensations to the last principle may be necessary. In any case, account should be taken of the country's current economic environment. Regulations might include a list of admitted assets on which ceilings may be set and requirements on the way in which investments should be valued.

RULE N°14 Regulation should not restrict free access to international reinsurance markets. Compulsory cessions of risk to domestic/national reinsurers should therefore be avoided. The collection and monitoring of information relating to reinsurance companies would be established. International cooperation is particularly important to obtain accurate information and should be strengthened.

RULE N°15 Insurance intermediaries should be registered in order to ensure their compliance with selected criteria. Insurance intermediaries should possess appropriate qualifications and provide adequate information to policyholder including disclosure of limits to their independence such as significant ties with insurance companies. Insurance brokers should possess either financial guarantees or professional liability insurance.

RULE N°16 Compulsory insurance may be justified in respect of certain forms of social protection and might be considered in other areas where the risks covered are particularly serious, or where premium payments should be divided on an equitable basis among the policyholders group under consideration. Compulsory insurance is particularly recommended for automobile third party liability. Guarantee funds could be created to compensate victims when there is no insurance cover. Tariffs for compulsory insurance should also be based on statistical data. Adequate monitoring systems should be established. Compulsory insurance should not be restricted to former monopolies or State owned companies.

RULE N°17 Regulations should allow for fair competition within the insurance and reinsurance market. The process of dismantling monopolies and the privatisation of government owned insurance companies should be strongly encouraged.

RULE N°18 The activities of insurance companies in the pensions and health insurance field should be encouraged within an appropriate regulatory and supervisory framework. Regulations should endeavour to ensure fair treatment between all private companies operating in these areas.

RULE N°19 Governments should strengthen co-operation in order to exchange information on insurance regulation and supervision, facilitate the monitoring of the activities of foreign insurance and reinsurance companies and promote the development of sound, modern and open insurance markets.

RULE N°20 The insurance industry should be encouraged to set up its own business guidelines and to develop adequate training structures. Self-regulatory principles and organisations, including professional bodies, can complement usefully the public supervisory structure.

- **Insurance Committee Secretariat  
Organisation for Economic Co-operation and Development, 1997**

## **Excerpts from the Takaful Act 1984**

### **Use of word “takaful”**

“family solidarity” means takaful for the benefit of the individual and his family;

“operator” means a company or a society which carries on takaful;

“takaful” means a scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose;

“takaful business” means business of takaful whose aims and operations do not involve any element which not approved by the Syariah;

### **Use of word “takaful”**

6. (1) No person other than an operator registered under this Act shall, without the written consent of the Director General, use the word “takaful” or any of its derivatives in any language, or any other word indicating that such person carries on takaful business in the name, description or title under which it carries on business in Malaysia or make any representation to such effect in any bill head, letter paper, notice or advertisement or in any other manner;

(5) The Director General shall also refuse to register an applicant unless he is satisfied-

- (a) that the aims and operations of the takaful business which it is desired to carry on will not involve any element which is not approved by the Syariah; and
- (b) that there is in the Articles of Association of the takaful operator concerned provision for the establishment of a Syariah Supervisory Council to advise an operator on the operations of its takaful business in order to ensure that it does not involve in any element which is not approved by the Syariah.

### **Deposits**

13. (1) An operator, while registered in respect of any class of takaful business, shall at all times have in respect of that business a deposit with the Accountant General of a value of not less than the amount as may be prescribed by the Minister.

### **Register of takaful certificates**

15. (1) Every operator registered under this Act shall establish a register of takaful certificate in such form as may be prescribed and shall, other than any prescribed exceptions, keep the Register at its principal place of business in Malaysia.



### **Establishment and maintenance of takaful funds; and allocation of surplus**

16. (1) Every operator registered under this Act shall establish and maintain in accordance with this section a takaful fund in respect of the class or each of the classes of takaful business carried on by the operator in Malaysia so far as that business relates to Malaysian certificates.

(3) In the case of a fund established in respect of family solidarity business, no part of the fund shall be allocated by way of takaful benefits to participants, except with the approval of a qualified actuary and out of a surplus of assets over liabilities as shown on the last statutory valuation of the fund and on the making of any such allocation that surplus shall be treated for purposes of this section as reduced by the amount allocated.

### **Requirements as to assets of takaful fund**

17. (1) the assets of any takaful fund under this Act shall be kept separate from all other assets of the operator, and shall not include assets comprised in a deposit under this Act, nor any amount on account of goodwill, the benefit of development expenditure or similar items not realizable apart from the business or part of the business of the operator.

### **Disclosure of interests by directors**

19. (1) every director of an operator who in any manner whatsoever has an interest, whether directly or indirectly, in an advance, a loan, a credit facility, or a financing facility from that operator shall as soon as practicable make to the operator a declaration in writing as to the nature and extent of his interest and the operator shall within seven days of its receipt furnish copies of that declaration to the Director General, its auditor, and all its directors.

(3) Every director of an operator who holds an office or possesses any property whereby whether directly or indirectly a duty or an interest may arise in conflict with his duty or interest as such the director shall declare at a meeting of the directors of the operator the act, nature, and extent of the conflict which may arise.

### **Establishment and maintenance of takaful guarantee scheme funds and payment of moneys out of the funds**

21. (1) There shall be established and maintained by the Director General in accordance with this section, takaful guarantee scheme funds in respect of general business and family solidarity business respectively carried out by the operator in Malaysia so far as the business relates to Malaysia certificates.

(2) There shall be paid into the takaful guarantee scheme funds through the Director General all such levies as may be imposed on and collected from operators in such instalments as the Director General may allow.

### **Re-takaful**

23. (1) An operator shall have arrangements consistent with sound takaful principles for re-takaful of liabilities in respect of risks undertaken or to be undertaken by the operator in the course of his carrying on takaful business.

### **Assumption of risk by operator**

25. (1) Subject to subsections (2) and (3), no operator shall assume any risk in respect of any general business unless and until –

- (a) the contribution payable is received by the operator or is guaranteed to be paid by such person in such manner and within such time as may be prescribed; or
- (b) deposit of such amount as may be prescribed is made in advance in the manner prescribed.

### **Misleading statement, promise or forecast inducing person to enter into contact of takaful**

28. Any person who, by any statement, promises or forecasts which he knows to be misleading, false, or deceptive, or by any fraudulent concealment of a material fact, or by the reckless making (fraudulently or otherwise) of any statement, promise or forecast which is misleading, false or deceptive, induces or attempts to induce another person to enter into or offer to enter into any contract of takaful with an operator shall be guilty of an offence and shall, on conviction, be liable to a fine not exceeding twenty thousand ringgit or to imprisonment for a term not exceeding one year or to both.

### **Opening of branch office**

30. Except with the prior approval in writing of the Director General, no operator shall open a branch office.

### **Disqualification of managing director, director, chief executive, principal officer or controller of an operator**

31. (1) Without prejudice to anything contained in the Companies Act 1965, any person who is a managing director, director, chief executive, principal officer or controller of an operator shall cease to hold office-

- (a) If he becomes bankrupt;
- (b) if he assigns his estate for the benefit of his creditors or makes an arrangement with his creditors pursuant to any law relating to bankruptcy; or
- (c) if he is convicted of an offence involving dishonesty or fraud

### **Power to inspect, to require information, etc.**

33. (1) The Director General may from time to time inspect under conditions of secrecy the books, accounts and transactions of any operator and of any of its branch officers.

(2) For the purposes of an inspection under subsection (1), the operator shall allow the Director General access to its books, accounts and documents and shall give such information and facilities as may be required to conduct the inspection:

### **Change in control of operator**

34. (1) There shall be no change in the control of an operator incorporated in Malaysia or registered as a society in Malaysia unless the Director General has given approval in writing for such change.

### **Licensing of brokers**

37. (1) No person shall act or hold himself out as a takaful broker unless he is the holder of a licence as a takaful broker granted by the Director General and is a member of an association of takaful brokers approved by the Minister.

### **Adjusters**

38. (1) No person shall act or hold himself out as an adjuster unless he is the holder of a licence as an adjuster granted by the Director General and is a member of an association of adjusters approved by the Minister.

### **Annual accounts and audit**

41. (1) An operator registered under this Act shall prepare the statements of account and other statements required by Part 1 of the Second Schedule and lodge them with the Director General (together with any prescribed fee) and Part III of that Schedule, so far as relevant to those statements, shall have effect with respect to their form and contents and to the time and manner in which they are to be lodged.

### **Actuarial investigations and reports as to family solidarity business**

42. (1) Subject to this section, an operator registered under this Act in respect of family solidarity business shall have an investigation made by a qualified actuary into the financial condition of that part of the takaful fund of its family solidarity business specifically allocated for payment of takaful benefits and a report thereon made to it by the actuary, and shall be lodged with an abstract of the actuary's report and certificate relating thereto and such statements as to that business as are required by Part II of the Second Schedule and Part III of that Schedule, so far as relevant to those documents, shall have effect with respect to their form and contents and to the time and manner in which they are to be lodged.

(2) Investigation under subsection (1) shall be made annually at the end of each accounting period as the operator may determine.

### **Power of Director General to issue directions**

47. (1) Where the Director General is satisfied that the affairs of an operator are being conducted in manner likely to be detrimental to the public interest, the interests of the participants, or the interests of the operator, the Director General may issue such directions to the operator as he considers necessary and may in particular require the operator-

- (a) to take such action or engage such management personnel as may be necessary to enable the operator to conduct its business in accordance with sound takaful principles;
- (b) to remove any of its directors whom the Director General considers not a fit an proper person to remain a director;
- (c) to take action as to the disposal or recovery of its assets;
- (d) to take steps for the recovery by the operator of sums appearing to the Director General to have been illegally or improperly paid;

(e) to cease renewal or cease issue of certificates of the classes of business to which the direction relates;

(f) To make such arrangements with respect to re-takaful as the Director General specifies.

**Knowledge of and statement by authorized agent to be deemed knowledge and statement by operator**

66. (1) A person who has at any time been authorised as its agent by a takaful operator and who solicits or negotiates a contract of takaful in such capacity shall in every such instance be deemed for the purpose of the formation of the contract to be the agent of the operator and the knowledge of such person relating to any matter relevant to the acceptance of the risk by the operator shall be deemed to be the knowledge of the operator.

**Regulations**

68. The Minister may make regulations for carrying into effect the objects of this Act, and for prescribing anything which under this Act is to be prescribed.

- **Takaful Act 1984**  
**Malaysia**