Achieving Common Standards in Takaful Regulations

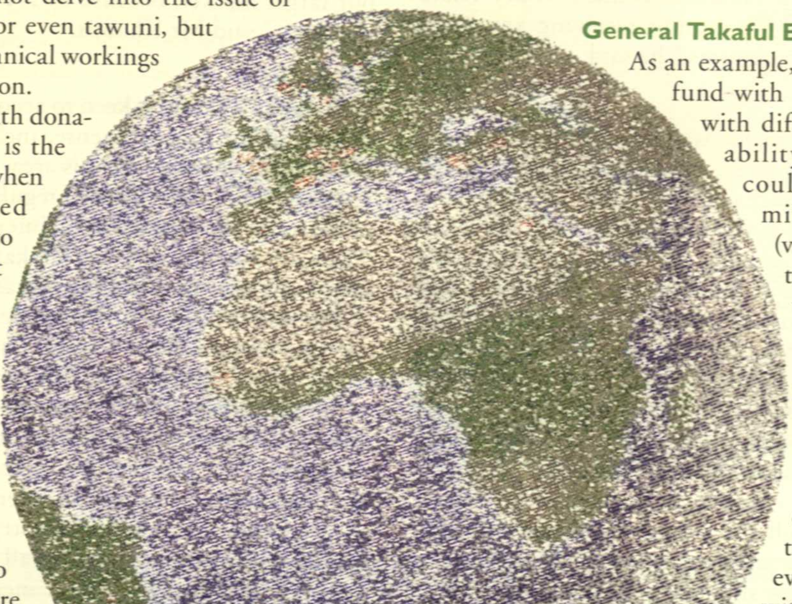
Expert Insight

Regulatory standards in the takaful world, or even the existence of regulations, vary greatly from jurisdiction to jurisdiction. In this article, **Mr Hassan Scott Odierno**, FSA, of Mercer Zainal Consulting, considers regulatory issues resulting from the donation concept, which is the backbone of takaful and is behind quite a bit of the differences of opinion in Islamic insurance worldwide.

This is not intended to be an all inclusive description of takaful regulations, but instead to highlight a few of the major issues which have caused disagreements and seemingly inconsistent practices between regions, jurisdictions and even operators within a jurisdiction.

The Definition of Donations

The backbone of takaful is in the concept of donations, where participants donate to a pool of funds for the purpose of providing mutual protection among all members of the pool. We will not delve into the issue of tabarru versus wakaf or even tawuni, but instead stick to the technical workings underlying this donation.



The key question with donations is: when exactly is the donation given? Is it when funds are transferred from the participant to the operator, or is it as funds are required to pay claims? This seemingly small point has huge implications in regulating takaful. A further question is: who exactly have we donated to?

In some cases, the donation is assumed to be given once funds are transferred to the operator. In this case, it is assumed that the amount given was fair and reasonable, and the funds do not belong to the participant any more. In this case, whatever happens to any excess funds, or surplus, is not the concern of the participant. He has donated this money in the concept of mutual help and has no expectations of anything back. In many cases, the operator will give any surplus back to the participant in the form of a hiba or gift.

If the donation is assumed to be given once funds are needed to pay claims, the issue of fairness comes into play. If the participant has overpaid at the time of the initial funds being given, he would eventually require a refund of the excess. Here, we would need to be careful that the amount returned to each participant is fair and reasonable, and is accordance with the actuarial concepts of policyholder's reasonable expectations (PRE) and treating customers fairly (TCF).

These two possibilities provide a spectrum of options ranging from a pure donation with no surplus being returned to the participant to a "conditional" donation with surplus being refunded in an actuarially fair manner. Between these, there is a range of options which include the operator receiving part of the surplus, and cross subsidisation between participants.

General Takaful Example

As an example, take a general takaful fund with a mixture of products with differing levels of profitability. In Malaysia, this could be a fund with a mixture of fire takaful (very profitable) and motor (less profitable). If the donation concept is taken at the time of payment of contributions, then these participants would not be adverse to receiving surplus on some sort of average basis for the fund as a whole, or even sharing the surplus with the operator or not receiving the surplus at all (all surplus remaining in the fund or given to charity).

However, if the conditional donation concept is taken, then the participants with a fire risk will not think highly of sharing his surplus with the motor risks. The participant may also not be thrilled with sharing his surplus with the operator.

Family Drip Product Example

A further example is the "drip" products commonly used in Malaysia. Here, the participant injects his funds into a savings account, after payment of wakala fees. From this fund, charges are dripped into the risk fund for payment of benefits. This product structure has some interesting benefits such as transparency and inherent fairness. Should the participant surrender his policy, he will know exactly what his surrender value is and the inherent transparency and fairness will be clear.

However, what happens if the investment experience is much worse than expected? If the participant's savings account runs out of money, what should be done? Should he be required to inject more funds into this account? If so, the operator should make it very clear in the benefit illustrations, brochures and contract that this is a possibility. Should the operator be forced to guarantee that the savings account will be sufficient? If so, this becomes a guaranteed investment contract, which is unlikely to be acceptable to the Shariah council.

A further option is that the participant would not be required to drip funds into the risk fund and still maintain coverage. This, in a technical sense, requires that the surplus of participants who have made these drips be used for the participants who have run out of funds. In a pure donation concept, this may be allowed; but with a conditional donation this is clearly in violation of PRE and TCF.

Ownership of the Risk Fund

Once a donation has been made, who have we donated to? Do the participants own the risk fund? Does the operator own this fund? Does someone else? If the operator owns the fund, can they reasonably be allowed to share in the surplus? This would amount to giving a gift to yourself under the pure donation concept (under the hiba concept of surplus distribution). Is this reasonable? If the participants own the fund, is there any basis for anything other than an actuarially exact basis of surplus distribution (ie conditional donation) or a pure donation in which no surplus at all is distributed?

From the regulators' point of view, the issue here is corporate governance. With a pure donation concept and the potential for free rein with respect to the giving of surplus as hiba, the regulator needs clear guidelines in place to ensure proper corporate governance of this surplus.

Risk-based Capital

One argument commonly heard for the sharing of surplus with the operators is that this sharing is needed for the achievement of an appropriate return on capital for the operator.

However, many times, the difficulties faced by operators here are due to regulations blindly following conventional norms. The return on capital of an operator is directly linked to the level of capital required to be held. Do takaful operations have the same level of risk as conventional insurance? Clearly the answer is no, as conventional insurance takes on risk whereas takaful manages risk.

These concepts will hopefully be clarified as risk-based capital takes hold worldwide, and the level of capital required to be set up is directly related to the risks inherent in the operations.

Conclusion

The donation concept is behind much of the differences of opinion worldwide, jurisdiction to jurisdiction, and operator to operator. The regulator, in conjunction with its Shariah council and actuary, will need to determine whether donations should be considered pure or conditional, as well as decide on the resulting technical and fairness issues.

By making decisions at the donation level and building regulations from there, consistency among regulations will be more achievable, and the inherent beauty of takaful will be given fertile ground to shine.

In summary, while it is unlikely that there will be common regulations for takaful worldwide, there can exist common standards and understanding of the fundamental concepts and decisions underlying takaful, with healthy respect and following of traditional regulatory concepts of corporate governance and responsibility.

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