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تكافل

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CORPORATE GOVERNANCE IN TAKAFUL

Corporate governance in any corporation is a challenge, as seen in the problems surfacing since 2001 with Enron and Worldcom. Corporate governance in insurance is even more of a challenge with the long term nature of life insurance in particular with the element of trust policyholders put in an insurance company to pay proceeds potentially many years into the future. In Takaful corporate governance is made yet further challenging with the addition of shariah issues and controls. This paper reviews corporate governance as it relates to Takaful and illustrates some of the current issues being faced by Takaful operators.

What is corporate governance?

Corporate governance is the set of processes, policies or laws affecting the way a corporation is directed, administered or controlled. This includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. Principal stakeholders normally include the shareholders, management, policyholders and the board of directors. Other stakeholders include employees, suppliers, banks and other lenders, regulators and the community at large. The key issue in corporate governance is to ensure accountability of individuals in an organization by trying to reduce or eliminate the risk of one party acting in its own interests against another party (aligning the interests of all parties).

Renewed interest in corporate governance since 2001 has been due to the collapse of Enron and Worldcom. The Sarbanes-Oxley Act (SOX) passed in the US in 2002 intended to restore public confidence in corporate governance. SOX had the goal of tightening corporate accounting controls and board oversight, which is excellent from a governance point of view. In Takaful however, there is an extra layer, namely shariah controls, along with the interaction between technical and shariah issues.

Strong board oversight over operations, accounting practices, methodologies and reporting is considered good corporate governance. To date much of corporate governance has focused on avoiding fraudulent activities and ensuring transparency. However, corporate governance can also be used as a differentiating factor from competitors. Due to the recent entry of large multinationals into Takaful, with their experience in SOX and other corporate governance testing, board oversight is expected to increase further.

Corporate Governance in Takaful

Takaful regulations vary by jurisdiction, with most jurisdictions regulating corporate governance either identical or very similar to conventional insurance operations. Takaful is informally also regulated by AAOIFI, the Accounting and Auditing Organization for Financial Institutions. There are several jurisdictions which explicitly require compliance with AAOIFI standards.

AAOIFI has four standards which relate to corporate governance:

- Shariah Supervisory Board: Appointment, Composition and Report
- Shariah Review
- Internal Shariah Review
- Audit and Governance Committee for Islamic Financial Institutions

Shariah Supervisory Board

This standard defines what exactly a shariah supervisory board is, how members are appointed, how the reports of the board look like, and publishing these reports. The shariah board shall be appointed by the shareholders in their annual general meeting upon recommendation of the board of directors. Dismissal of a member of the shariah board shall require recommendation by the board of directors and subject to approval by the shareholders. The reports of the shariah board should have a clear statement that it is management's responsibility to properly comply with the Islamic Shariah rules and principles, with the shariah board's responsibility to form an independent opinion based on their review of the operations and report to management. This statement in particular is of interest as the reports of the shariah councils of many Takaful operations do not have such a statement, with the implication being that responsibility remains with the shariah council. Considering that the shariah council being external to the company is not able to oversee the day to day operations of the Takaful operator this is a weakness in corporate governance.

The scope of the report should confirm that the shariah board has performed appropriate tests, procedures and review of the work as appropriate, including testing of each type of transaction. Where appropriate the report of the shariah board should include a clear statement that the financial statements have been examined for the appropriateness of the shariah basis of allocation of profit between the equity holders and the investment account holders.

It is recommended that the fatwas, rulings, and guidelines issued by the shariah board during the year be published by the Islamic Financial Institution (IFI). In many Takaful operations the activities of the shariah board is not published. It is likely that with increased publication of shariah board activities that there would be less divergence in shariah opinions and Takaful models. This divergence and potential for divergence is another weakness in corporate governance for Takaful.

Shariah Review

This standard gives the definition, principles and objectives of a shariah review, along with procedures and responsibility for compliance and implementation. The review is an examination of the extent of compliance of the IFI in all its activities with the shariah. This includes contracts, agreements, policies, products, transactions, memorandum and articles of association, financial statements, reports, circulars and whatnot. While the shariah board is responsible for forming and expressing an opinion on the extent of the IFI compliance with the shariah, the responsibility for compliance rests with management. The shariah board shall assist management by providing guidance, advice and training relating to compliance with the shariah. However, the shariah review does not relieve management of the responsibility to ensure all transactions are in accordance with the shariah.

The review shall be documented in terms of aspects such as sample selection criteria and sizes, taking into consideration complexity and frequency of transactions. The review shall include all activities, products, and locations. The shariah review procedures include:

i. Obtaining an understanding of management's awareness, commitment, and compliance control procedures for adherence to the shariah.
ii. Reviewing of contracts, agreements etc
iii. Ascertaining whether transactions entered into during the year were for products authorised by the shariah board.
iv. Reviewing other information such as circulars, minutes, operating and financial reports, policies and procedures, etc
v. Consultation / coordination with advisors such as external auditors.
vi. Discussing findings with management.
vii. Presentation to shareholders at the annual general meeting.

It is unclear to what extent such shariah reviews are taking place currently and how extensive such reviews are. A point of concern is how often should this review take place?

Also, management is repeatedly put in the position of responsibility for compliance with all aspects of shariah. What if the CEO or key personnel are non-Muslim? At minimum it sounds like shareholders need to put some sort of compliance processes in place to ensure shariah is followed, similar to the development of SOX procedures for non-shariah issues.

Internal Shariah Review

This standard defines the internal shariah review, scope of work and procedures for the review. Review is to be carried out by an independent division / department or part of an internal audit department, with the objective being to ensure the management of the IFI discharges their responsibilities in relation to the implementation of the rules and principles as determined by the IFI's shariah board. A written report of internal shariah reviews is to be given to the board of directors at least quarterly.

Audit and Governance Committee (AGC) for Islamic Financial Institutions

This standard outlines the importance, functions, responsibilities, and reporting of the AGC. The AGC enhances transparency and disclosure in financial reporting and enhances the public's confidence of the IFI as genuine in its application of shariah rules and principles. The responsibilities of the AGC are reviewing internal controls including the system for monitoring compliance with shariah rules and principles and legal requirements as well as considering the adequacy of controls over significant areas where loss or embarrassment could be caused to the IFI.

Reviews of accounting practices and audit plan including any issues related to the appointment, resignation or dismissal of shariah board members is included as is the review of interim and annual accounts and financial reports including compliance with all AAOIFI standards. AGC will also review the reports of the internal shariah review, and ensure that external shariah reviews take place.

Corporate Governance of Takaful in Malaysia

The above AAOIFI standards provide an excellent base for Corporate Governance for takaful as it relates to shariah issues. Developments such as SOX provide a base for financial corporate governance. What about implicit expectations of fairness and equity, which although might not be in the letter of the law of shariah, is an implicit fundamental principle of Islam itself? This aspect of corporate governance is perhaps most advanced in the Takaful world in Malaysia, with the various guidelines (known as JPIT) spelling out the roles and expectations of various parties. The most relevant to corporate governance as it relates to implicit expectations of fairness and equity is JPIT 10: Guidelines on the role of the Appointed Actuary.

JPIT10, Section 3.5:

It is the continuing responsibility of the appointed actuary to advise the Takaful operator on his interpretation of the certificate holders' reasonable expectations. In general terms, he should have regard to the broad management philosophy of the Takaful operator and the approach to the treatment of certificate holders vis-à-vis shareholders. He should also take all reasonable steps to ensure that the Takaful operator's future certificate holders are not misled as to the expectations. This acknowledges that the actuary is in a unique position to interpret expectations and monitor brochures, sales illustrations and other materials in terms of wordings and underlying assumptions to ensure participants are not being misled.

JPIT10, Section 4.11

The appointed actuary must also report to the directors on the extent to which it would be appropriate to distribute any surplus to certificate holders or shareholders, and make recommendations for its specific allocation. This puts the amount of surplus to distribute, and the way of distributing surplus, in the hands of the actuary.

JPIT10, Section 4.12

The appointed actuary should satisfy himself that the [surplus] distribution is fair and

equitable to all parties concerned. In particular, he should take into account:

(a) Statutory requirements that the bank [Bank Negara Malaysia, the regulator] may specify

(b) Equity between certificate holders and shareholders

(c) Equity among different groups of certificate holders

This places the responsibility of keeping the fairness aspect of takaful not on the shariah board or on management, but on the actuary. This sounds easy, but in real life maintaining fairness is a challenge due to the technical nature of takaful.

Issues

There are a number of examples of corporate governance issues and concerns unique to Takaful, several of which are shown below.

Qard Hasan:

Qard Hasan is the giving of an interest free loan should there be a deficit in the Takaful risk fund. Comparing the cash flows of a conventional and a Takaful company makes the corporate governance concerns of Qard Hasan clear. In a conventional insurance company sample cash flows might be the following:

	Insurance Fund	Shareholders' Fund
A. Assets	900	1,000
B. Liabilities	1,000	0
C. Surplus / (deficit) (A-B)	(100)	1,000
D. Injection from shareholders	100	(100)
E. Net surplus/(deficit) (C+D)	0	900

In a Takaful company under identical conditions the following cash flows might arise:

	Takaful Fund	Operators' Fund
A. Assets	900	1,000
B. Liabilities	1,000	0
C. Surplus/(deficit) (A-B)	(100)	1,000
D. Qard from Operator	100	0
E. Net surplus/(deficit) (C+D)	0	1,000

The Takaful operator has managed to put itself in a competitive advantage relative to conventional insurers, as it can take more risks painlessly. In conventional insurance if there is a deficit, the shareholders provide an injection. In Takaful if there is a deficit the operator provides a qard hasan loan. As a loan it is an asset of the operators' fund. However, in the takaful fund it is accounted for as an injection. By right a loan would not help in the deficit position of the risk fund, as the loan income would be matched by a corresponding liability. This is consistent with the original intention of qard hasan loans in Takaful: a means to fund a scenario where the fund runs out of money, not to handle statutory deficits.

The issue of qard hasan has some similarities with financial reinsurance, where the question always arises as to the limit when reinsurance becomes a loan. In financial reinsurance there must be a reasonable chance of losses on the part of the reinsurer in order to classify as reinsurance and not a loan. Is there an equivalent aspect in Takaful which we can use to solve this issue of qard hasan, or is it clear that qard hasan should be an injection from the point of view of the operator's fund?

In this example as it stands now, the operator can sell unprofitable business in large volumes, continue to receive their wakalah fees and show large profits, and yet tie up their operators fund in interest free loans. Is this proper corporate governance? What

about those profitable policies that were sold and now do have any surplus to share as they have funded part of the losses of the unprofitably sold business? Is this fair?

Retakaful Quota Share:

In a normal quota share arrangement, the retakaful operator would take a portion of every gross contribution. The retakaful operator would then pay a commission of a certain percentage of retakaful contributions back to the Takaful operator. The Takaful operator itself will pay out commissions to the direct agent. In some cases the Takaful operator pays out more in commissions than it has received from the retakaful operator (and retakaful is a high percentage of the risk). Who pays for this deficit? It is currently the other participants. Is this fair? Is this proper corporate governance?

Surplus Distribution:

In many Takaful operations the operator shares in surplus. Surplus however, is only an estimate in many cases. For instance:

	Insurance Fund
A. Assets	1,500
B. Liabilities	1,000
C. Surplus / (deficit) (A-B)	500

This 500 looks like real money which can be shared from the point of view of the shariah board. This is not the case however for many types of policies. The liability (assuming general takaful) consists of unearned contribution reserve plus Incurred But Not Reported Reserves (IBNR).

For short tailed coverage the level of IBNR is fairly well known. For long tailed coverage such as coverage where the legal system is involved we might not know even remotely how well the IBNR has been estimated for another 5 - 7 years. Therefore, is it proper corporate governance for the operator to share in this surplus, when if the reserves are later increased causing losses the operator will not share in these losses?

This is magnified many times in jurisdictions which do not require actuarial sign off on IBNR, as management is setting the reserves, and then taking a portion of the surplus. This is a huge incentive for management to under-reserve in some years and make up several years of under-reserving in one year (not sharing in the resulting deficit).

Takaful As a Cooperative

We often say that Takaful is similar to a cooperative. To be more precise the Takaful fund itself operates very similar to a cooperative. In a cooperative there are generally annual meetings of the members of the cooperative where management and shareholders are held accountable by the members. Why is there nothing equivalent done in Takaful? Shouldn't management be required to present its results to the participants, the shariah board presents its rulings and decisions to participants, and the actuary present his issues regarding the fund to participants?

Considering the technical nature of Takaful, perhaps a "participants' advocate" needs to be appointed during these participant annual meetings, funded by the Takaful fund rather than management. Such an advocate would be responsible for reviewing various aspects of operations, such as surplus sharing, levels of fees, and reserve levels and methodology. The Participants advocate would be at the same level as the person setting such surplus sharing and whatnot. In many markets this will be an actuary, whereas in others it will be an auditor or accountant. This advocate will need to be independent of the Takaful operator.

Conclusions

Corporate governance is the aligning of the interests of all parties, to minimize the risks of moral hazards. Far from being a cost, proper corporate governance can be a true competitive advantage. The challenge of corporate governance in Takaful is the interaction between technical concepts and shariah concepts. With this in mind the actuary needs to be heavily involved. The participants should also have their fair say.

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For group products, because of the large sum covered and the way group products are administered, underwriting is necessary to be implemented for cases above the Free Cover Limit to mitigate anti-selection risks and in order to protect the funds from depleting. Since group products are often taken up by the contract owner (and not the individuals) as part of an employee benefit scheme, the element of intention to tabarru may not be as strong as individual family products taken by individuals. Actually, for group family, there exists a clause called pre-existing clause in the group master contract which may help mitigate risks to the takaful operator. The only problem is that the clause has not been strictly observed by most takaful operators. This is because not many takaful operators are aware that Free Cover Limit exists to assist in the administration of the group products (due to the volume of data involved) and the pre-existing clause exists to protect the takaful operator of anti-selection for cases below the Free Cover Limit. They think that all sums covered below the Free Cover Limit has to be paid out, resulting in a high claims ratio in the product, and the takaful operators implementing more stringent underwriting rules.

In the spirit of ta'awun or mutual co-operation, underwriting is an issue that needs to be looked at by takaful operators. After all, "Al Ghorm bil Ghonm" or "No Pain No Gain" is a concept often associated with risks management and profit making and therefore the maxim should also be upheld by takaful operators.

If you would like more information on ICMIF and its services to the takaful sector, please contact Sabbir Patel (*sabbir@icmif.org*), or visit *www.takaful.coop*.

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