

Policies and Developments

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Policies and Developments

I. Policy Direction in 2004

The takaful industry has emerged as one of the vital components of a comprehensive Islamic financial system, capable of effectively contributing to the overall economic growth and financial stability. Efforts continued to be taken to further strengthen the overall infrastructure supporting the development of a resilient and robust takaful industry. During 2004, the policy thrust centred on enhancing the institutional infrastructure, regulatory and prudential framework, Shariah and legal infrastructure, as well as consumer awareness and protection.

Enhancing Institutional Infrastructure

Further progress was made in 2004 to enhance the diversity and capacity of players as part of the broad strategy of enhancing the institutional infrastructure of the takaful industry.

- Approval in principle was granted to a local banking group to conduct takaful business, through the registration of a new subsidiary of the banking group. The move is in line with the need to complement the robust development of the Islamic banking industry, while leveraging on synergies of the existing infrastructures of the banking group.
- Capital raising exercise by takaful operators was completed in 2004 following the directive issued by Bank Negara Malaysia in November 2003, which imposed a minimum paid-up capital requirement of RM100 million for a takaful company. The minimum capital increase was mostly secured through rights and bonus issues. As the capital raising exercise was fully subscribed by the existing shareholders of the takaful operators, no change in control was triggered within any of the takaful operators.

Enhancing Regulatory, Prudential and Operational Framework

Regulatory

The Bank has enhanced the regulatory framework governing the industry through the implementation of several measures which are aimed at strengthening corporate governance practices, improving the transparency of financial reporting as well as the effectiveness of the anti-money laundering framework.

- **The Guidelines on Directorship for Takaful Operators**

The Guidelines were issued to strengthen the effectiveness of the board of directors and senior management in the overall management of a takaful operator. Given the high degree of commitment required from board members, the Guidelines enunciate higher requirements as to the fitness and propriety of directors. The Guidelines specify the requirements relating to the appointment and re-appointment of directors, as well as duties and responsibilities of directors and chief executives that serve to ensure their competence, independence and integrity in managing the affairs of takaful operators.

- **The Guidelines on Related Party Transactions for Takaful Operators**

The Guidelines set out the general standards, practices and procedures to be adopted by takaful operators in relation to dealings with related parties. Additional requirements are imposed for specific transactions relating to payment of dividends, purchase and sale of properties, settlement of contributions and sharing of common resources such as computer systems and physical premises with a related party. These requirements seek to ensure that related party dealings entered into by a takaful operator are fair, reasonable and not prejudicial to the interest of the takaful operator itself, its participants, claimants or creditors. The Guidelines also require

proper disclosure on related party transactions to be made in the statutory annual returns to Bank Negara Malaysia and the monthly returns for the periods ending June and December each year through the Takaful Operators' Statistical System (TOSS).

- **The Guidelines on Financial Statements for Takaful Operators**
The Guidelines were issued to standardise the format for financial reports of takaful operators. By setting out the minimum disclosure requirements of financial statements of takaful operators, the Guidelines aim to improve the comparability and usefulness of the reports, particularly in facilitating assessment of the performance of takaful operators by various stakeholders. The Guidelines were developed drawing from the accounting standards as issued by the Malaysian Accounting Standards Board for insurance, with the necessary modifications on relevant accounting policies for takaful as endorsed by the Bank Negara Malaysia's Shariah Advisory Council (SAC). Takaful operators are required to adopt the minimum disclosure requirements as set out in the Guidelines for financial statements from financial year-end beginning 2004.
- **The Anti-Money Laundering Act 2001 – Verification Procedures**
A minimum guide on verification procedures was introduced to be applied for applications by prospective customers to participate in takaful plans commencing 1 October 2004 with the aim of preventing the takaful industry from being used as a conduit for money laundering activities. The minimum guide was issued to facilitate compliance by takaful operators with Section 16(2) of the Anti-Money Laundering Act 2001 which requires due diligence processes on prospective customers to be performed and properly documented. To reinforce the effort on combating money laundering, Bank Negara Malaysia's supervisory resources are also being channelled to review the adequacy of anti-money laundering measures established at the

supervised entities. The Bank's continuing effort in this area has led to increased emphasis placed by takaful operators in instituting the necessary measures to detect and deter money laundering activities.

Prudential

In an effort to further strengthen the prudential framework governing the takaful industry, the scope of takaful schemes is expanded through the contribution of shareholders in rectifying any deficit in the takaful risk funds. Under this arrangement, shareholders of a takaful operator will be required to make an outright transfer of assets, as and when required and based on the principle of *tabarru'*, into the takaful risk funds. The requirement has been endorsed by the SAC in line with the need to ensure the systemic stability and sustainability of the takaful industry.

Operational

Several important initiatives were taken during the year to promote improvements in market practices and operational efficiency in the takaful industry.

- **New Policy on Takaful Coverage for Islamic Financing**
The policy requires Islamic banking institutions (IBIs) to offer takaful as the first choice of protection for Islamic financing that needs coverage. Exception to the rule is permitted only where the customer's individual preference for conventional insurance was indicated or where takaful coverage is not available in the market. In addition, the use of takaful coverage by the IBIs is mandatory where the cost of coverage, i.e. contribution, constitutes part of the financing package. The policy was formulated upon consultation with the SAC to preserve the integrity of the Islamic financial services industry in terms of its total compliance with Shariah.
- **Greater Utilisation of Technology via JPJ eINSURANS**
An industry-wide initiative was undertaken to improve operational efficiency through on-line submission of motor cover notes by takaful operators to the Road Transport Department

(RTD) for the purpose of road tax issuance. Bank Negara Malaysia had also conducted examinations on the three e-cover notes gateway service providers which provide such services to insurers and takaful operators in order to ensure the readiness of their information technology (IT) systems and infrastructure before the 'live' implementation of JPJ eINSURANS by RTD. The JPJ eINSURANS which was implemented in January 2005 is also expected to eliminate problems relating to forged motor cover notes, and hence, uninsured vehicles on the road as RTD will only recognise e-cover notes.

- **Enforcement of the Cash-Before-Cover (CBC) Requirements**

The statutory requirement of the CBC stipulates that a takaful operator is not permitted to assume any risk in respect of motor takaful unless the contribution payable is received by the takaful operator. To engender greater market discipline in the management of contributions of motor takaful and the issuance of cover notes, takaful operators will now be subject to compound for offences under section 25 of the Takaful Act 1984, and the relevant regulations in respect of direct clients. In addition, takaful operators are required to make adequate provisions for motor contributions outstanding for more than 30 days, instead of six months as previously practised.

- **Centralised Database for Motor Repairs Estimation**

A collaborative effort with the industry was initiated in 2004 to oversee efforts to improve the centralised database on motor parts and labour costs of Motor Research Consortium Sdn. Bhd. (MRC) as used by insurers, takaful operators, adjusters and motor repairers. A joint working committee was formed to undertake this task in line with the need to maximise the use of the database that was first introduced in 2001 to reduce subjectivity in claims estimation.

- **Revised Conditions for Arrangements between Takaful Operators and Vehicle Franchise Holders on Repair of Vehicles**

The conditions that were imposed by the Bank on takaful operators upon granting the approval to enter into arrangements with vehicle franchise holders for repair of damaged vehicles were revised in 2004 in line with market developments. The revised conditions include the requirement to utilise the centralised database of MRC for motor repairs estimation. In addition, takaful operators are advised to stop paying for the promotion of the vehicle franchise holder's customer benefit programme should the franchise holder fails to comply with any of the conditions.

Strengthening Shariah and Legal Infrastructure

During the year, steps were taken to strengthen the Shariah and legal framework for the development of Islamic banking and takaful.

- The Shariah framework is strengthened further with the issuance of the Guidelines on the Governance of Shariah Committee for Islamic financial institutions. The Guidelines are aimed at streamlining the functions and duties of the Shariah Committee of takaful operators as well as enlarging and reinforcing the role of the SAC in order to ensure better Shariah governance in the takaful industry. This followed the amendments made in 2003 to the Central Bank of Malaysia Act 1958 and the Takaful Act 1984 which enhanced the role and functions of the SAC as the sole authority on Shariah matters pertaining to Islamic banking and takaful. The Guidelines also stress on the independence and integrity of the Shariah Committees through the restriction on the appointment of any member of the SAC or a takaful operator's Shariah Committee as a member of another takaful operator's Shariah Committee. This move would benefit the Islamic financial services industry in the long run as it paves the way towards creating and enlarging the pool of qualified and well-

trained Shariah scholars competent in Islamic finance.

- Further amendments were made to the Income Tax Act 1967, the Real Property Gains Tax Act 1976 and the Stamp Act 1949 in accordance with the tax neutrality policy for Islamic banking and finance introduced by the Government in the 2005 Budget. Under the tax neutrality framework, the Inland Revenue Board (IRB) will exempt additional instruments and transactions executed to fulfil Shariah requirement from additional stamp duty and tax payment. Bank Negara Malaysia has been empowered under the laws as the authority to recommend to the IRB to exempt such additional instruments and transactions from stamp duty.

Enhancing Consumer Awareness and Protection

Efforts were also directed at strengthening the consumer protection infrastructure and enhancing financial literacy towards increasing public confidence in the takaful industry.

- **The Financial Mediation Bureau**
The Financial Mediation Bureau (FMB) was established in early 2005 to lend support for efficient dispute resolution process involving the diverse range of financial products and services provided by the financial institutions under the supervision of the Bank. To enhance the consumer redress mechanism at industry level, the FMB will take charge of settling complaints or disputes on banking, insurance, Islamic banking and takaful matters between consumers and the financial institutions. As an integrated mediation bureau with an expanded scope of responsibility, the FMB replaces and combines the functions of the formerly separate establishments for banking and insurance known as the Banking Mediation Bureau and the Insurance Mediation Bureau.
- **Minimum Standard on Product Disclosure and Transparency in Marketing Medical and Health Takaful Plans**
A circular on the minimum standard was issued to specify market conduct

requirements relating to disclosure and the advisory process for adherence by takaful operators and their intermediaries. This is to ensure that prospective consumers are better able to make informed decisions. The focus on achieving best practice standards in marketing medical and health takaful plans is among the efforts to facilitate the orderly development of the medical and health takaful business.

- **Consumer Education Programme**
New educational materials on 'investment-linked takaful' and 'personal accident takaful' were issued under the 10-year Consumer Education Programme (CEP) on insurance and takaful known as 'InsurancelInfo'. The InsurancelInfo is a collaborative effort between the Bank and the insurance and the takaful industries as part of the strategies to raise consumer awareness and appreciation of insurance and takaful. The educational material will be displayed in the InsurancelInfo website and in the form of printed booklets for dissemination to the public.
- **The Malaysia International Halal Showcase (MIHAS) and the Islamic Banking and Takaful Expo (IBTE)**
The inaugural MIHAS and the annual IBTE were organised in 2004 by the Islamic Dakwah Foundation Malaysia and the Association of Islamic Banking Institutions Malaysia respectively. These events, in which the Bank participated, have brought the key stakeholders closer in the development of Islamic finance.

II. Supervision of the Takaful Industry

The comprehensiveness of the Bank's oversight over the takaful industry encompasses the regulatory and supervisory functions. Since 2003, Bank Negara Malaysia had embarked on a strategic shift in its supervisory philosophy and approach, which has resulted in a transformation from a bottom-up, audit-based supervision approach to one that is more holistic and forward-looking. This is achieved via the implementation of Risk Based Supervisory Framework since August 2004.

Risk Based Supervisory Framework

The Risk Based Supervisory Framework (RBSF) is a cyclical, continuous, on-going dynamic process of planning, carrying out specific supervision activities. The RBSF was implemented with the continued aim of ensuring that all supervised entities adopt sound business practices and are financially sound and robust. The new supervisory process uses a structured approach to assess an insurer or takaful operator's risk profile, its financial condition, and the adequacy of its operational management and risk management systems, in order to form an overall assessment of the insurer or takaful operator's health and the likelihood of key risks materialising in the future. Different emphasis is accorded to supervised entities with different risk profiles, which in turn promotes a stronger risk management culture in the industry. To minimise duplication, the Bank would leverage partly on the work done by external and internal auditors, appointed actuaries and other professionals, in respect of the fairness of financial statements, control environment, operational compliance with policies and procedures and adequacy of technical liabilities. This forward-looking approach will enable the Bank to allocate resources optimally, and greater supervisory attention can be given to supervised entities that are systemically important and/or have higher risk profiles.

The risk assessment process begins with identifying the significant activities of the supervised entity, and the inherent risks associated with these activities. This is achieved through continuous off-site monitoring of financial and market information, on-site examinations, as well as dialogues with the senior management of the supervised entity. This will enable the Bank to assess the effectiveness of the entity's risk management systems relative to its risks, as well as the adequacy of its capital and profitability in mitigating the net risks.

In line with Bank Negara Malaysia's focus on consumer protection, supervision on the conduct of insurers and takaful operators will continue to be carried out to ensure that rights of policyholders and the public are appropriately protected. Under the new framework, market conduct supervisions are dealt with separately using a separate supervisory framework. The results of both supervisory processes will be consolidated to reflect appropriately the insurer's or takaful operator's overall position in terms of its financial condition and market conduct.

As part of the supervisory efforts, each supervised entity is also subjected to continuous monitoring of its resilience to economic shocks under stressed conditions. In conjunction with this, insurers and takaful operators are required to submit the results of their stress tests on a half-yearly basis. The stress test incorporates a set of minimum parameters, as prescribed by the Bank with flexibility given to the supervised entities to adopt their own assumptions for certain parameters.

The supervisory activities of the Bank are also focused on several specific areas which are

important to the overall safety and soundness of the supervised entities. These specific areas include the supervision on information systems (IS) and fraud surveillance.

Information Systems Supervision

Bank Negara Malaysia has taken steps to enhance the overall IS governance as well as to promote IS best practices in the supervised entities in response to the rapid development of technology in the insurance and takaful environment. These include on-site examination, off-site monitoring, issuance of guidelines on the management of the IS environment and improving the standards of IS supervision by benchmarking against other proven IS auditing standards. For better assessment of the IS environment and to ascertain the soundness of the IS operations of the insurers and takaful operators, the Bank has enhanced the quality of its IS supervision function by implementing a new methodology for on-site examination, Information Systems Risk Assessment (PRISM). This methodology provides a more balanced appraisal of the IS environment by linking the IS practices and risks to the business requirements and processes. Effort is also being directed at

developing a system to enhance the off-site monitoring function through a database of information on the development and usage of technology by the insurers and takaful operators, which would provide a mechanism for early warning on potential systemic risks and benchmarking of core processes across the insurers and takaful operators.

Fraud Surveillance

A fraud surveillance system has also been put in place, through the Electronic Fraud Information Database System (eFIDS) which captures incidences of fraud in the insurance and takaful industries. The database enables the Bank to identify new modus operandi of frauds and alert the insurance and takaful industries so as to prevent further occurrences of frauds. To reinforce the effort on combating fraud, anti-fraud committees comprising the officials of the Bank and associations representing the insurance and takaful industries were set up in 2004. The committees are responsible to identify and develop recommendations for better coordination and cooperation between the Bank, law enforcement agencies, insurance and takaful associations in their efforts to combat fraud.

The ultimate objective of supervision is to promote a sound and robust insurance and takaful industry, as well as to protect the interest of policyholders and maintain public confidence in the financial system. Going forward, the strategic focus will be on financial surveillance, risk management and market practices, corporate governance, management quality and public accountability as the cornerstones for strengthening the financial resilience of insurers and takaful operators amidst a more competitive and liberalised environment. Efforts continue to be taken to ensure that the supervision approach is appropriate and relevant, and that the Bank is equipped with the necessary skills and capabilities to effectively manage the challenges ahead.

III. International Developments

In 2004, the Bank and the industry players continued to actively participate in initiatives to develop takaful on the global front.

The Bank Negara Malaysia-Islamic Development Bank (IDB) Memorandum of Understanding

The memorandum of understanding (MoU) between the Bank and the IDB was signed on 30 June 2004 which among others seek to promote and expand takaful and retakaful businesses among the Organisation of Islamic Conference (OIC) member countries. Specific measures have been identified to be undertaken collaboratively by both parties. Focus will be directed at promoting ASEAN Retakaful International (L) Ltd. as the main retakaful operator for OIC member countries. With the signing of the MoU, the Malaysian takaful operators are expected to play a more active role in venturing abroad.

Developing Eight (D-8) Cooperation

Progress was made in the D-8 countries initiative during the inaugural meeting convened by the Bank on 13 July 2004 to set up a mechanism for cooperation in the development on takaful among the regulatory and supervisory authorities of the D-8 countries. The meeting agreed on the setting up of two working groups in the areas of education and training as well as financial infrastructure development to be led by Malaysia and Egypt, respectively.

ASEAN Retakaful International (L) Ltd. (ARIL)

Efforts were continued to reinforce the position of ARIL as the main retakaful operator for the D-8 and OIC countries. A key initiative towards this end was the partial completion of the capital raising exercise by way of bonus and rights issues to existing shareholders. The exercise had resulted in an increase in the paid-up capital of ARIL to USD14 million from USD4 million. Following the move to strengthen its financial position and business capacity, ARIL has laid out plans to further increase its capital to USD60 million by 2008.