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PART I - PRELIMINARY

Objective

1.1 As custodian of public fund, a takaful operator has a fiduciary duty to ensure that funds under its management are invested in a prudent and sound manner to avoid undue risk or loss. A takaful operator, as manager of takaful funds is entrusted to manage contributions made by participants to ensure that the payments of takaful benefits, as defined in the takaful contract, are efficiently carried out and participants' reasonable expectations can be achieved.

1.2 In ensuring that takaful operators' fiduciary duty is met, this Guidelines on Investment Management for Takaful Operators (Guidelines) sets out the relevant policies that should be observed in managing investment portfolios and the associated risks. The Guidelines is issued to facilitate better understanding amongst takaful operators on Bank Negara Malaysia's (the Bank) **minimum expectations** with regards to the governance of takaful funds' investment activities.

1.3 The Guidelines has been developed to achieve the following objectives:

- (i) To institute strong and effective governance of investment activities of the takaful fund;
- (ii) Various measures are established to safeguard the interests of takaful participants;
- (iii) An appropriate risk management framework is in place in identifying, monitoring, controlling and mitigating the various risks arising from investment activities; and
- (iv) To ensure sound management of assets appropriate with the nature and profile of the takaful fund's liabilities.

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1.4 The approach for investment management adopted by each takaful operator may vary depending on a wide range of factors, including the size, level of sophistication and complexity of the takaful operator's investment activities. Regardless of the approach, basic principles such as accountability and responsibility of the board of directors and senior management, the need for robust risk management policy and adequate monitoring and controls should be applicable to all takaful operators.

1.5 Takaful operators are expected to observe that the objectives, management and the activities of investments are in compliance with Shariah principles at all times. Takaful operators must ensure that the officials or representatives that handle and manage investments portfolio understand and comply with the requirements of this Guidelines.

Applicability

1.6 The Guidelines shall apply to all takaful operators¹ registered under the Takaful Act 1984 with effect from 20 April 2009.

Legal and Regulatory Provision

1.7 The Guidelines is issued pursuant to section 69 of the Takaful Act 1984 and should be read in conjunction with:

- (i) section 17 of the Takaful Act 1984;
- (ii) Takaful (Prescribed Financial Institution, Loan and Investment) Regulations 2003; and
- (iii) other relevant guidelines or circulars that may be issued by the Bank from time to time.

¹ Include registered professional retakaful operators and international takaful operators.

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PART II – POLICY REQUIREMENTS

Investment and Risk Management Policy

2.1 Takaful operators are required to have in place written investment and risk management policies describing the overall investment policies and strategies and the appropriate risk management framework.

2.2 The overall investment policies and strategies should be communicated to all staff involved in investment activities, and should incorporate the following main elements:

- (i) the investment objectives, both at company and fund-specific levels;
- (ii) the investment styles, i.e. the adoption of passive or more active investment management² in relation to each level of decision making;
- (iii) the risk and liability profile of the takaful fund;
- (iv) the strategic asset allocation, i.e. the long-term asset mix for the main investment categories including respective limits. For instance, the establishment of limits for the allocation of assets by geographical area, markets, sectors, counterparties, currency, and the definition of the scope for investment flexibility;
- (v) the overall policy on the selection of individual securities and other investment titles;
- (vi) the extent to which the holding of certain types of assets is restricted or disallowed, e.g. illiquid or highly volatile assets, or

² Passive management refers to an investment transactions that maintain predefined strategic mix between asset categories, or within an asset category, traditionally in accordance with market indices. Active management refers to investment strategies where transactions deviate from the predefined strategic mix to achieve a risk-return profile different from that implied by the strategic portfolio composition. Active investment strategies involved changing the portfolio mix between equities and fixed income investment; altering the geographical allocation; or, in an equity portfolio, over- and underweighting of shares against an index; and, in a fixed income portfolio, increasing or decreasing the duration of the portfolio.

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where independent (i.e. external) verification of pricing is not available;

- (vii) the policy on the usage of derivatives and structured products; and
- (viii) the framework of accountability for all asset transactions.

2.3 In developing the investment strategy of the takaful fund, takaful operators shall take into account the reasonable expectations of participants. Takaful operators shall ensure that investment strategy is consistent with the disclosure made under the respective products.

2.4 Due to the different nature of the liabilities, takaful operators shall consider separate investment strategy for family and general takaful business in situations where both businesses are undertaken by the same entity. For family takaful business, takaful operators shall also consider separate investment strategies for participants' investment fund and participants' risk fund due to potential differences in objectives of both funds. The investment strategy for participants' risk fund shall take into account the ability of the fund to meet takaful liabilities. The investment strategy for the participants' investment fund shall take into account the ability of the fund to meet future tabarru' deduction and reasonable expectation of investment return. Takaful operators shall also consider whether certain products need to have a specific investment strategy which commensurate with the risk and liability profile of the products.

2.5 Takaful operators should have a comprehensive risk management framework. The framework should include, amongst others, the setting of investment risk management strategies and policies, developing oversight mechanism with appropriate review, monitoring and control procedures. The risk management framework must also cover the risks associated with investment activities that may affect the coverage of takaful liabilities and capital positions. The main risks include market, credit and liquidity risks.

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2.6 Takaful operators should ensure that investment risk exposures are clearly defined and measured, using appropriate risk measurement methods. The methods and tools used to measure those risks should reflect the nature and complexity of the risks inherent in a portfolio. Takaful operators should also establish, enforce and monitor investment risk limits.

2.7 The design of the risk management system should allow identification, measurement and assessment of investment risks. The system should be able to aggregate risks at various levels, for example at the portfolio's level and the company's level, at any given time. Where a takaful operator is a member of a group of companies, the risk management system should allow the investment risk exposures to be monitored at group level. A takaful operator should also be able to demonstrate that it meets risk management standards as a group and on an individual basis.

2.8 Takaful operators shall establish clear governance procedures over investment decision making process. The process and rationale for such decisions shall be adequately documented.

2.9 Takaful operators shall ensure proper segregation of duties to ensure sufficient check and balance is in place within the organisation. For example, investment risk management function and the investment operations function should be independent of each other.

Monitoring and Control

2.10 As part of good risk management practices and to ensure proper monitoring and control of the investments, takaful operators are required:

- (i) to establish adequate internal controls to ensure that assets are managed in accordance with the takaful operator's approved

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investment policies, and in compliance with legal, accounting and relevant risk management requirements. These controls should ensure that investment procedures are documented and subject to effective oversight;

- (ii) to have in place clear segregation of roles and responsibilities in the settlement of transaction, i.e. segregation between front, middle and back office functions. This includes appropriate segregation of responsibilities for measuring, monitoring and controlling investment-related transactions, from the front office functions;
- (iii) to have in place rigorous audit procedures that include full coverage of the investment activities that enable timely identification of internal control weaknesses and operating system deficiencies. If the audit is performed internally, takaful operators must ensure that:
 - It should be independent of the function being reviewed;
 - Audit plans are endorsed by the Audit Committee of the board of directors;
 - Audit report to the board of directors should assess the takaful operators' compliance with the overall investment policies and procedures; and
 - Internal auditors are equipped with the requisite level of skills and competencies in investment risk management.

Takaful operators shall be guided by the 'Guidelines on Minimum Audit Standards for Internal Auditor' issued by the Bank with regards to the supervisory expectations on internal audit functions;

- (iv) to establish procedures for monitoring and managing the asset-liability position that effectively ensure the investment activities and asset positions are appropriate in relation to the liability and risk profiles;
- (v) to put in place contingency plans to mitigate the effects arising from deteriorating market conditions. Takaful operators should have

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ready plans that describe the actions to be taken under a variety of scenarios. For example, the takaful operator may have a ready plan in a scenario where liquidity might be a concern. The plans should be regularly reviewed to ensure that these plans remain robust, particularly under changing operating environment. The takaful operator should periodically assess the company's readiness to undertake effective responses to deteriorating market conditions;

- (vi) to undertake regular resilience testing for a range of market scenarios and changing investment and operating conditions in order to assess the appropriateness of asset allocation limits; and
- (vii) to ensure that key staffs involved in investment activities have the necessary skills and experience.

2.11 The extent and nature of internal controls adopted by each takaful operator may vary but the following procedures should be considered:

- (i) identification of personnel who are responsible and accountable for all transactions involving sales and purchase of assets;
- (ii) observations of restrictions on the empowerment of all parties to enter into any particular transaction. This will require close and regular communication with those responsible for compliance, legal and documentation issues in the takaful operator;
- (iii) all parties to the transaction agree with the terms of the deal. Procedures for sending, receiving and matching confirmations should be independent of the front office function;
- (iv) formal documentation is completed promptly;
- (v) positions are properly settled and reported, and that late payments or late receipts are identified;
- (vi) all transactions are carried out in conformity with prevailing market terms and conditions;

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- (vii) authority and dealing limits are strictly enforced and all breaches are reported and remedial actions are taken promptly;
- (viii) independent checking of rates or prices and choice of rates should not solely rely on dealers for rate/price information;
- (ix) set out the process for recommending, approving, and implementing decisions; and
- (x) prescribe the frequency and format of reporting to relevant internal and external authorities.

2.12 In addition, takaful operators should describe the method for classifying investments and the basis for valuing investments including those that are not regularly traded. While the board of directors of the takaful operator is responsible to ensure compliance with accounting standards related to assets, the impact of accounting standards on investment strategy and results should be carefully considered.

2.13 There should also be in place procedures to monitor and control takaful fund's exposure to fluctuations in profit rates, foreign exchange rates, and market prices.

2.14 In terms of Shariah governance on investment, takaful operators should put in place appropriate procedures to ensure investment portfolios are Shariah-compliant including the process required in respect of returns from tainted/non-halal income. The roles of the takaful operators' Shariah Committee shall be clearly spelled out to ensure the effectiveness of the Shariah governance.

2.15 Regular and timely reports of investment activity to senior management and the board of directors should be produced to disclose the takaful fund's exposure in clearly legible terms, including quantitative and

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qualitative information. The frequency and details of reporting should commensurate with the nature, complexity and sophistication of the investment strategy. Reports should at least include the following areas:

- (i) Details and commentary on investment activity;
- (ii) Details of positions by asset type;
- (iii) An analysis of credit exposures by counterparty; and
- (iv) Details of the relative positions of assets and liabilities e.g. maturity mismatch.

2.16 Takaful operators should ensure that the latest investment and risk management policies are properly documented and available as and when requested by the Bank.

Roles of Board of Directors and Senior Management

2.17 The ultimate accountability for the investment of takaful funds lies with the board of directors of the takaful operator. The investment and risk management policies must therefore be ratified and approved by the board of directors. While the senior management is expected to implement the overall investment policy, the board of directors retain the ultimate accountability for the company's investment policy and procedures, regardless of the extent to which associated activities and functions are delegated or outsourced.

2.18 The board of directors, or sub-committee appointed by the board, may delegate the responsibility for the day to day implementation and monitoring to the senior management. Senior management has the responsibility in ensuring the comprehensiveness of the investment and risk management policies of the takaful operator. This includes the responsibility for the development of detailed operational policies and procedures and ensuring that the investment and risk management policy approved by the board of directors is being implemented and monitored effectively. Senior management should, on annual basis, review the

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investment and risk management policies. In discharging this responsibility, senior management should ensure that effective channels of communication of investment policies to all relevant functions or personnel are in place and periodic review on the adequacy of resources with sufficient level of skills and competencies should be performed. On an annual basis, senior management of the takaful operators should provide an assurance to the board of directors that policies and procedures relating to investment and risk management policies are sufficient and effective, and no material breach of the policies occurred.

Investment Oversight Function

2.19 As part of improved governance and risk management practices expected of takaful operators under the Guidelines, each takaful operator shall have in place an investment oversight function that is responsible in ensuring the effectiveness of the investment policies and procedures of the takaful operator. This oversight function is also responsible in ensuring the implementation of investment policies in line with the approval from the board of directors, and put in place a timely and regular reporting of the takaful operator's investment activities. Takaful operators must ensure that the personnel in this oversight function should be suitably qualified to perform such responsibilities.

2.20 The investment oversight function shall report regularly to the board of directors. If the board of directors delegates authority to the investment oversight function to make investment decisions on its behalf, the investment oversight function shall report at each meeting of the board of directors on all material decisions made by the function and the status of the investment portfolio.

2.21 To facilitate the implementation of this oversight function, it is recommended as a best practice that each takaful operator establishes an investment committee, the terms and references of which must be approved by

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the board of directors. In terms of the composition of the investment committee, this committee may comprise members of the board of directors and senior management officers of the takaful operator.

Outsourcing of Investment Activities

2.22 Where the investment management activities are outsourced to a third party, takaful operators must ensure that the outsourced entity is being engaged under a contract that, inter alia, sets out the policies, procedures and limits of the investment mandate. The policies, procedures and limits for the outsourced fund must meet the same objective of the takaful operator's investment policies and procedures. Takaful operators must establish comprehensive policies and procedures to govern the strategic investment policy of the takaful funds outsourced, establish an effective risk management system to monitor and continuously assess material risks, and for the takaful funds to be kept separately and not co-mingled with other funds managed by the outsourced entity. Takaful operators must regularly monitor the performance of the outsourced entity, at least semi-annually, and take appropriate actions if the investment performance of the outsourced entity would adversely affect the investment returns to participants or if participants' reasonable expectations cannot be achieved.

2.23 For this purpose, takaful operators must ensure that adequate expertise and resources are retained in-house to support the monitoring function of the outsourced entity. Takaful operators must ensure that, under the terms of the contract, they regularly receive sufficient information to evaluate the compliance of the outsourced entity with the investment mandate. The board of directors of the takaful operators shall continue to be accountable to manage the risks arising from the outsourcing arrangements. Takaful operators shall also remain responsible for the fiduciary duty and ethical aspects of the outsourced activity.

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2.24 It is the responsibility of the takaful operator that arrangements for outsourcing the investment activities to the third party are in compliance with supervisory expectations specified under the 'Guidelines on Outsourcing for Takaful Operators' issued by the Bank.

Prudential Investment Limits

2.25 Takaful operators shall be subject to investment limits stipulated in existing guidelines and circulars, and any other written guidelines, circulars and directions that may be issued by the Bank from time to time. Takaful operators shall also observe internal investment limits approved by the board of directors, provided the internal limits do not contravene the investment limits stipulated by the Bank.

2.26 Notwithstanding these limits, the Bank may impose requirements on an individual takaful operator to invest in a specified manner, or restrict or prohibit a takaful operator from investing in certain asset classes or individual asset to safeguard takaful funds. Such requirements, restrictions or prohibitions will form part of supervisory actions as a result of the Bank's assessment of a takaful operator's risk profile and investment risk management function.