



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Internal Capital Adequacy Assessment Process for Takaful Operators

Applicable to:

1. Licensed takaful operators
2. Licensed professional retakaful operators

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PART A OVERVIEW

1. Introduction

- 1.1 A licensed person is expected to actively manage its capital adequacy by taking into account the potential impact of its business strategies on its risk profile and overall financial resilience. This expectation is outlined in the BNM/RH/GL 004-23 *Risk-Based Capital Framework for Takaful Operators* (RBCT).
- 1.2 The Internal Capital Adequacy Assessment Process (ICAAP) is the overall process to be undertaken by a licensed person to ensure that it has adequate capital to meet its capital requirements on an on-going basis. The ICAAP is an integral part of the Bank's Risk-Based Supervisory Framework, aimed at ensuring a licensed person's capital adequacy and the Bank will review and evaluate a licensed person's ICAAP and where necessary, take the appropriate supervisory action to address any areas of concern.
- 1.3 This policy document sets out the requirements for the conduct of an ICAAP by a licensed person and outlines the supervisory review and evaluation of the ICAAP of a licensed person. The policy document further specifies, for an active management of capital adequacy which requires, a licensed person to have in place the following:
- (a) an individual target capital level (ITCL) that reflects its own risk profile and risk management practices that is set by conducting the appropriate stress and scenario tests;
 - (b) a capital management plan that takes into account its strategic business direction and the changing business environment; and
 - (c) the processes required or involved, as the case may be, for the monitoring and ensuring the maintenance of adequate capital above the ITCL at all times that commensurate with its risk profile.

2. Applicability

- 2.1 This policy document is applicable to licensed persons as defined in paragraph 5.2.

3. Legal provisions

- 3.1 The requirements in this policy document are specified pursuant to section 57 and section 155 of the Islamic Financial Services Act 2013 (IFSA).
- 3.2 The guidance in this policy document is issued pursuant to section 277 of IFSA.

4. Effective date

- 4.1 This policy document comes into effect on 1 January 2017.

5. Interpretation

- 5.1 The terms and expressions used in this policy document shall have the same meanings assigned to them in the IFSA, as the case may be, unless otherwise defined in this policy document.
- 5.2 For the purpose of this policy document –
- “**S**” denotes a standard, an obligation, a requirement, specification, direction, condition and any interpretative, supplemental and transitional provisions that must be complied with. Non-compliance may result in enforcement action;
- “**G**” denotes guidance which may consist of statements or information intended to promote common understanding and advice or recommendations that are encouraged to be adopted;
- “**licensed person**” collectively refers to a licensed takaful operator and a licensed professional retakaful operator;
- “**licensed professional retakaful operator**” refers to a professional retakaful operator licensed under section 10 IFSA to carry on solely retakaful business;
- “**board**” means the board of directors of a licensed person; and
- “**senior management**” refers to the chief executive officer and senior officers of a licensed person.

6. Related legal instruments and policy documents

- 6.1 This policy document must be read together with other relevant legal instruments and policy documents that have been issued by the Bank.

7. Policy documents superseded

- 7.1 Not applicable

PART B POLICY REQUIREMENTS

8. General requirements

- S** 8.1 A licensed person shall carry out its ICAAP to ensure that it has adequate capital to meet its capital requirements on an ongoing basis. A licensed person must include the following key elements in carrying out its ICAAP:
- (a) board oversight and senior management responsibilities;
 - (b) comprehensive risk assessment;
 - (c) individual target capital level (ITCL);
 - (d) stress testing¹;
 - (e) sound capital management; and
 - (f) monitoring, reporting and review of the ICAAP.
- S** 8.2 A licensed person shall integrate its ICAAP into its business planning, risk management processes and day-to-day operations to ensure that findings or conclusions from its ICAAP are realistic and reliable.

9. Board oversight and senior management responsibilities

- S** 9.1 The board and senior management shall ensure that the licensed person maintains an adequate level and quality of capital for its risk profile and business plan. For this purpose, the board and senior management shall attain a sound understanding of the nature and materiality of risks inherent in the licensed person's activities.
- S** 9.2 In exercising its oversight responsibilities, the board shall:
- (a) approve the licensed person's risk appetite/ risk tolerance, which includes risks inherent in the takaful funds, and capital management framework;
 - (b) deliberate and approve the mitigation plans and actions towards the ICAAP results; and
 - (c) ensure that senior management discharge its responsibilities for the development and effective implementation of the ICAAP.
- S** 9.3 Senior management shall be responsible to develop and effectively carry out its ICAAP by:
- (a) ensuring that all key elements of the ICAAP in paragraph 8.1 are established and functioning effectively in accordance with this policy document and capital management framework approved by the board, and that these shall subject to independent review as provided in paragraph 14.6 to 14.8, on a periodic basis. In particular, senior management shall ensure that the following are in place:
 - (i) systems to assess risks, risk mitigation strategies and approaches to relate capital to the level of risk; and
 - (ii) processes for ensuring and monitoring the adequacy of capital against material risks.

¹ Stress testing must be conducted in accordance with the requirements in the policy document on Stress Testing for Insurers and Takaful Operators.

- (b) ensuring that a comprehensive assessment of capital adequacy is conducted at least annually (or more frequently if necessary) as part of capital planning, with the view of ascertaining whether the ITCL and other capital management thresholds continue to remain appropriate, and the results of the assessment must be reported to the board;
- (c) establishing policies and procedures relating to the ICAAP, and must communicate these effectively throughout the organisation and establish a method for monitoring their compliance; and
- (d) ensuring that appropriate documentation is maintained for all key elements of the ICAAP described in paragraph 8.1.

10. Comprehensive risk assessment

- S** 10.1 A licensed person shall ensure that risks beyond those covered in the RBCT are factored into the ITCL which must be established by the licensed person under paragraph 11.1 To achieve this, a licensed person must have in place a process to assess its risk profile and quality of risk management including additional risks that are not included or not adequately provided for (having regard to the quality of risk management of the licensed person) in the regulatory capital maintained under the RBCT.
- G** 10.2 Additional risks referred to in paragraph 10.1, that may be considered by a licensed person include liquidity risk, group risk, catastrophe (including environment) risk as well as the risk of the underestimation of liabilities that may result from guarantees provided by the shareholders whether implicitly or explicitly, over and above the amount of provision already provided for at the 75% level of confidence.
- G** 10.3 In assessing the additional risks which are not included or not adequately provided for under the RBCT, a licensed person may include a consideration of:
 - (a) risks that are attributed to the specific nature of a licensed person's business activities including the marketing of products with special features (e.g. investment-linked with capital guarantees);
 - (b) risks that are associated with a specialised target market (e.g. specialised risks under fire business);
 - (c) risks that are not explicitly captured under the RBCT such as:
 - (i) business-related risks
 - (A) strategic risk, i.e. risk of losses resulting from strategic initiatives, e.g. merger and acquisitions, expansions, etc.;
 - (B) reputation risk, i.e. risk of loss of business volume after an event that damages the reputation of a licensed person;
 - (C) business risk, i.e. risk arising from changes in a licensed person's businesses, including the risk that a licensed person may not be able to carry out its business plan and desired strategy, for example, earnings shortfall due to a fall in business volumes;
 - (ii) liquidity-related risks
 - (A) asset liquidity risk, i.e. the exposure to loss in the event that insufficient liquid assets will be available, from among the

assets supporting the takaful certificate obligations, to meet cash flow requirements of the participants obligations when they are due. Losses due to liquidity risk can occur when a licensed person has to borrow unexpectedly or sell assets for an unanticipated low price, or due to the inability to dispose assets at the prevailing market price in view of the lack of depth in the market; and

- (iii) catastrophe risk
 - (A) risk of losses that potentially arise due to severe epidemic, natural catastrophe, terrorist attack, etc.
- (d) risks that are associated with Shariah non-compliance (SNC) (e.g. loss of profit or income due to the holding of SNC investments which may be a result of improper market practices or arising from operations that are not in accordance with a licensed person's Shariah Committee's advice or Shariah Advisory Council's resolutions).

- G** 10.4 In most cases, a reasonable attempt at quantification of key risks is necessary, rather than just using qualitative tools such as scorecards. This is so that the risk assessment can be used to support other components of the ICAAP, for example, to guide the parameterisation of adverse scenarios for stress testing. The approach to quantification may reflect the complexity and significance of the risk category. For example, catastrophe risks may require detailed analysis of individual contracts across a range of participants and classes of business to identify any accumulation of exposures.
- S** 10.5 In carrying out an assessment of its risk profile, a licensed person shall consider all material risks arising from the business and operating environment which, at minimum, shall include the following factors:
 - (a) size and complexity of its business;
 - (b) growth and expansion strategies; and
 - (c) nature, scale and complexity of asset mix, and product offering, composition and market segments.
- G** 10.6 A licensed person may choose to include other factors in assessing the risk profile that are appropriate to their circumstances, for example, internally adopted risk measures that are more stringent than the criteria outlined in this policy document.
- S** 10.7 A licensed person, in making an assessment of the quality of its risk management, shall consider the effectiveness of its operational and risk management structure, and whether it commensurate with the licensed person's risk profile, which, at minimum, shall include:
 - (a) quality of board and senior management oversight and overall governance processes;
 - (b) adequacy and appropriateness of internal policies and procedures;
 - (c) appropriateness of organisational and incentive structures;
 - (d) effectiveness of internal control functions such as internal audit, financial control, compliance and risk management;
 - (e) adequacy of supporting systems infrastructure for business and control functions;

- (f) effectiveness of monitoring of risk exposures and escalation processes; and
 - (g) adequacy of resources and staffing, with appropriate expertise and experience.
- G** 10.8 A licensed person may build on existing components of its risk management processes, specifically in areas pertaining to risk identification and measurement. A licensed person may conduct enhancements where necessary to ensure that the assessments are at an adequate level of details to support identification of significant adverse scenarios that will be used in stress testing and determination of ITCL level.

11. Individual Target Capital Level

- S** 11.1 A licensed person shall set an ITCL above the Supervisory Target Capital Level (STCL) that reflects its overall risk tolerance and appetite set by the board, its own risk profile and risk management practices and shall operate at capital levels above the ITCL at all times.
- S** 11.2 A licensed person shall derive the ITCL through an iterative process of stress tests performed on a range of financial positions and corresponding capital adequacy ratios (CAR), until a suitable target level is determined. In determining the ITCL, the licensed person shall ensure at minimum that:
- (a) the ITCL takes into account plausible adverse scenarios that may arise over a one year projection period;
 - (b) in the event that it has a CAR at the ITCL before the occurrence of selected plausible adverse scenarios, the licensed person will be able to maintain a CAR above the STCL of 130% after the occurrence of those scenarios; and
 - (c) the ITCL takes into account all changes in risk profile arising from planned business and operational activities over the period of projection.
- S** 11.3 A licensed person shall determine the impact of the stress tests on the Participants' Risk Fund (PRF) and how this affects the financial position of the licensed person in relation to its ability to provide *qard* in the future. In particular, a licensed person shall assess the possibility of the PRF being in deficit in the future by considering the impact of the stress tests on PRF, the ability of PRF to repay outstanding *qard* and the potential impact to the licensed person in the event the outstanding *qard* is deemed irrecoverable.
- S** 11.4 A licensed person shall assess the availability of surplus in individual PRF to absorb losses. A licensed person with a high level of surplus in individual PRF to absorb losses, such that, it does not need capital support from Shareholders' Fund, shall identify the minimum level/ limit of surplus in individual PRF which if the licensed person breaches such level/ limit, it will require a review of its ITCL. This is to ensure that the ITCL, which is set at company level, is directly linked to the availability of surplus within the PRF.

- S** 11.5 A licensed person shall not equate the approach for determining ITCL under the ICAAP as equivalent to an internal model framework.
- G** 11.6 The ITCL is set by considering how the capital requirements, as computed in accordance with the RBCT, vary under plausible adverse scenarios. A licensed person may utilise appropriate models that have been developed internally for this purpose, where the output is expressed as plausible adverse scenarios for stress testing to determine the ITCL.
- S** 11.7 A licensed person shall ensure that the ITCL provides a robust threshold in the management of a licensed person's capital adequacy, where a breach of this threshold shall trigger timely responses by senior management of a licensed person to restore capital to the ITCL (including restrictions on payment of dividends) and heightened board scrutiny.

12. Stress testing

- S** 12.1 A licensed person, where appropriate, shall modify the work done for the purpose of fulfilling the requirements of the policy document on stress testing¹ to derive the ITCL. At minimum, a licensed person shall modify the following key areas:
- (a) the projection time spans over a horizon of one year; and
 - (b) the impact of plausible adverse scenarios must be tested on the ITCL instead of the actual capital level.
- G** 12.2 Modification under sub-paragraph 12.1(b) may require hypothetical financial positions to be used as base scenarios which will be stressed and iteratively adjusted until a suitable level that meets the requirements of an ITCL is found, as stated in paragraph 11.2. As an example, a licensed person with current CAR of 300% may consider testing a base scenario of 200%, will need to adjust its actual balance sheet to arrive at a hypothetical balance sheet that has a CAR of 200%. In order to produce such hypothetical balance sheet, a licensed person may reduce the level of retained profits through dividend payments.
- S** 12.3 In conducting the stress test, a licensed person shall consider the inter-linkage between the Participants' Investment Fund (PIF) and PRF for takaful products where any adverse scenario in PIF may give implications to the financial position of PRF².
- S** 12.4 A licensed person shall not factor in the planned corrective actions under the capital management plan to reduce the magnitude of stress factors or the impact of stress testing on the capital position when using stress testing to set the ITCL as these corrective actions are remedial actions to restore capital levels post occurrence of stress scenarios.

² For example, credit-related products under the dripping model, due to the reserving method imposed on this type of product.

13. Sound capital management

- S** 13.1 Based on material risks identified, a licensed person shall assess their overall capital adequacy, and develop a strategy for maintaining adequate capital levels consistent with their risk profile and business plans. This shall be reflected in the licensed person's capital planning process.
- S** 13.2 A licensed person shall ensure that the stress tests conducted for capital planning process covers a projection period of at least three years.
- S** 13.3 In respect of the capital planning process, the licensed person shall:
- (a) ensure that the process involves taking into account current and anticipated changes in the licensed person's risk profile, such as that reflected in its business plan, and forecast of the related impact on capital; and
 - (b) integrate projected capital needs with its budgeting and financial forecasting processes.
- G** 13.4 An example for paragraph 13.3(b), is where, a licensed person may initiate a capital raising exercise to finance strategic investments or specify an earnings retention policy to support future growth whilst maintaining adequate target capital levels.
- S** 13.5 A licensed person shall consider the results of the stress tests in evaluating the appropriateness of capital thresholds and corrective actions. A licensed person shall also be mindful of the particular stage of the business cycle in which they are operating, given the potential changes in the external environment that could affect their risk profile.
- G** 13.6 In assessing capital adequacy, a licensed person may adopt a more stringent definition of capital instrument than that specified under the RBCT based on assessments of these instruments' ability to absorb losses on both going concern and gone concern bases under different market conditions. The results of such assessments may be reflected in the capital planning process.
- S** 13.7 A licensed person must have a Capital Management Plan (CMP) that documents their capital planning process. The CMP must contain, at a minimum, the following:
- (a) a list of thresholds that will act as triggers for a licensed person to take actions to ensure the adequate capital levels are maintained at all times whereby–
 - (i) the thresholds capture important capital levels such as the ITCL and the STCL;
 - (ii) the thresholds are based on other forms of triggers such as earnings deterioration, single large losses or a specified market event; and
 - (iii) the determination of thresholds is based on internal management criteria or other objectives of the licensed person, for example, to achieve a certain level of financial strength for strategic purposes or to retain a financial strength rating;

- (b) the corrective actions that are triggered by each threshold;
 - (i) the corrective actions including steps to reduce the level of inherent risk (for example, de-risking of the asset or liability portfolio) or increase the capital available (for example, recapitalisation exercise or capital injection from shareholders);
 - (ii) the corrective actions must be specific, actionable and realistic having regard to how the realisation of adverse scenarios is likely to affect the licensed person's risk management activities (in contrast to normal operating conditions).
 - (c) details on how corrective actions can effectively restore the financial position of the licensed person to the relevant threshold and can be implemented in a timely manner to prevent further deterioration of the financial position; and
 - (d) in particular, it must be shown that the licensed person is able to carry out the corrective actions in the context of the scenarios giving rise to the trigger. The intensity of the corrective actions must increase with the extent to which the threshold level is breached.
- G** 13.8 With reference to paragraph 13.7(a), there may be at least one threshold above the STCL of 130% and at the ITCL to ensure that corrective actions pre-empt any breaches of these levels. Other factors which are not directly related to capital deterioration or leading indicators of risk may be considered in addition to just using CAR levels as thresholds.
- G** 13.9 As an example for paragraph 13.7(b), raising additional capital may require significant lead time, and can be costly or difficult, especially at times when market conditions are unfavourable. In this case, a capital transfer from a parent company might not be possible if the parent company's solvency is similarly impaired in the adverse scenario tested or prospects for recapitalisation through rights issues might be severely limited in a recession.

14. Monitoring and review of ICAAP

- S** 14.1 A licensed person shall have in place a process for continuous monitoring and regular review of all key elements of the ICAAP. A licensed person must ensure that the monitoring process shall include reporting of any breaches or potential breaches of the thresholds referred to in paragraph 13.7 to the board and senior management immediately. A breach or potential breach of the ITCL must be reported by a licensed person to the Bank immediately.
- G** 14.2 With reference to paragraph 14.1, continuous monitoring of the elements of the ICAAP will enable the licensed person to track changes in the risk profile, risk management activities, operating environment and financial position so that timely actions can be taken to prevent any breaches of capital target levels.
- S** 14.3 A licensed person shall schedule regular reviews of key elements of the ICAAP, with interim reviews that may be triggered by monitoring activities or changes to the business and operating environment. The review must be conducted at least annually, taking into account how new experiences, emerging trends and changes to the business and operating environment impact the following areas:
- (a) the assumptions, methods and results of the assessments on the risk profile and quality of risk management;
 - (b) the assumptions, methods and results of the stress tests;
 - (c) the appropriateness of the ITCL in the light of any changes to (a) and (b); and
 - (d) the thresholds and corrective action plans under the CMP.
- S** 14.4 A licensed person must ensure that the review undertaken under paragraph 14.3 will conclude on the appropriateness of the areas stipulated in paragraph 14.3(a) to (d) and recommend any necessary changes for approval by the board or senior management as appropriate.
- G** 14.5 A licensed person may conduct comprehensive reviews every 3 years if there are no changes to the usual business and operating environment. This may be supplemented by additional reviews triggered by monitoring activities of a licensed person.
- S** 14.6 If a licensed person conducts a comprehensive review under paragraph 14.5, the licensed person shall update the Bank on a timely basis on the outcome of any internal or external reviews conducted on ICAAP.
- S** 14.7 A licensed person shall ensure that the risk management and capital management processes relating to the ICAAP is subject to independent review to ensure their integrity and consistent application. A licensed person shall schedule regular independent reviews depending on the changes to the business and the operating environment. This review must cover, at least an assessment of:
- (a) whether the licensed person's ICAAP is appropriate to the size, nature of business, and complexity of its activities;

- (b) the quality and completeness of data inputs to the ICAAP;
 - (c) the reasonableness and validity of methodologies, assumptions and scenarios;
 - (d) the robustness of the licensed person's ICAAP-related risk monitoring and reporting systems (e.g. the content and timeliness of ICAAP-related management reports as well as reports to the board); and
 - (e) the performance and appropriateness of the use of third-party vendors and products, services and information, to the extent that they are employed within the ICAAP.
- S** 14.8 A licensed person shall ensure that the independent reviewer shall not be directly involved in the development, implementation or oversight of the ICAAP but have the necessary expertise and experience to conduct the review effectively, in which the review shall incorporate any necessary recommendations for improvements and senior management's response, including specific action plans to the recommendations.
- G** 14.9 The review may be conducted by a suitably resourced internal audit function, external auditor, a consultant or any other party that meets the independence criteria as mentioned in paragraph 14.8. Different aspects or elements of ICAAP may be reviewed by different independent reviewers based on their areas of expertise.
- S** 14.10 To support the monitoring and review process, a licensed person must maintain detailed documentation of all key elements of the ICAAP which shall cover at least the following areas:
- (a) policies and procedures for all processes;
 - (b) issues and recommendations raised by the board or independent review function;
 - (c) ITCL, the thresholds for corrective actions to be taken by a licensed person and the scenarios underpinning the ITCL and bases for selection of other capital thresholds;
 - (d) corrective actions for each threshold;
 - (e) description of key risks and methods and assumptions used in risk assessments and stress testing, including all relevant bases for and limitations of the choice of methods and assumptions;
 - (f) qualitative and quantitative data, sources of data and treatment of data;
 - (g) results and associated reasonableness checks;
 - (h) internal and external reports and reviews; and
 - (i) changes made and analysis on the impact of the changes.

PART C SUPERVISORY REVIEW AND EVALUATION

15. Supervisory review and evaluation

- G** 15.1 As part of the Bank's Risk-Based Supervisory Framework, the soundness of a licensed person's ICAAP will be reviewed and evaluated against the expectations set out in Part B of this policy document. This review will consider the comprehensiveness of the ICAAP and the quality of risk management to form a view on the appropriateness of the licensed person's ITCL and its capacity for meeting the targets.
- G** 15.2 The Bank may require the licensed person to take action to improve its capital and risk management processes as well as adjust the ITCL and/ or require the licensed person to compute and report their ITCL at a more granular level if it is not satisfied with a licensed person's ICAAP.
- G** 15.3 While the board and senior management of a licensed person maintains primary responsibility for the licensed person's capital adequacy, the Bank reserves the power to intervene at an early stage to prevent a licensed person's capital from falling below the level that the Bank deems adequate to support the licensed person's risk profile and will require rapid remedial action if capital is not maintained or restored.
- G** 15.4 When a licensed person's CAR breaches its own ITCL but remains above the STCL, the licensed person will be subject to the Bank's assessment on the circumstances of the breach and the licensed person's remedial plans to restore CAR above its ITCL, before deciding on the level of supervisory intervention required. This may include altering the risk profile of the licensed person through business or operational restrictions or directing a licensed person to raise additional capital, where the Bank determines that the expectations of this policy document have not been satisfactorily met. Continued deterioration of a licensed person's CAR below its ITCL will attract increasing levels of supervisory attention.