BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Takaful Operational Framework

Exposure Draft

Applicable to:
1. Licensed takaful operators
2. Professional retakaful operators

Issued on: 18 May 2018 BNM/RH/ED 033-2

Background

The Takaful Operational Framework (TOF), first issued in 2010, specifies requirements for the management of takaful operations in the areas of operational model, segregation of funds and management of takaful funds operations.

Highlights

This exposure draft (ED) is being issued following a review of the existing TOF aimed at further clarifying the operationalisation of Shariah contracts. Specifically, this ED introduces operational requirements for Shariah contracts commonly adopted by licensed persons in their takaful operations, namely *tabarru`* (donation), *wakalah* (agency), *mudarabah* (profit-sharing), *qard* (loan) and *hibah* (gift). These proposed takaful operational requirements complement the Shariah standards and operational requirements issued by the Bank by providing additional guidance dealing with the specificities of takaful business.

The ED also seeks to strengthen takaful fund management practices by setting out requirements to strengthen internal controls over the establishment of additional takaful funds to ensure their sustainability and prudent management.

Collectively, these revisions seek to spur greater innovation in takaful while further safeguarding the position of takaful participants.

The Bank invites written comments on the ED, including suggestions for particular issues/areas to be clarified or elaborated further and any alternative proposals that the Bank should consider. To facilitate the Bank's assessment, please support each comment with a clear rationale, accompanying evidence or illustration, as appropriate.

In addition, licensed persons are requested to respond to the specific questions set out in this ED.

Responses must be submitted to the Bank by **18 July 2018** to –

Pengarah
Jabatan Perbankan Islam dan Takaful
Bank Negara Malaysia
Jalan Dato' Onn
50480 Kuala Lumpur

In the course of providing your feedback, you may direct any queries to –
Muhaizam Ismail at aizam@bnm.gov.my or 03-26988044 (ext: 7261); and
Nurul Iman Azwan at nuruliman@bnm.gov.my or 03-26988044 (ext: 7858).

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PART A OVERVIEW

1. Introduction

1.1 A licensed person carrying on the business of takaful has the duty to conduct takaful operations in the best interest of takaful participants. This includes operating the business in a sound and prudent manner, while ensuring compliance with Shariah.

1.2 Accordingly, the TOF outlines the parameters to govern the operational process relating to the takaful funds and shareholders' fund which aims to achieve operational efficiency of takaful business, sustainability of takaful funds and safeguard the best interest of the takaful participants.

2. Applicability

2.1 This policy document is applicable to a licensed person as defined in paragraph 5.2 of this policy document.

3. Legal provisions

3.1 The requirements in this policy document are specified pursuant to sections 29(2), 57, 90, 93(2), 93, 94, 95 and 155 of the Islamic Financial Services Act 2013 (IFSA).

3.2 The guidance in this policy document is issued pursuant to section 277 of the IFSA.

4. Effective date

4.1 This policy document comes into effect six (6) months after its date of publication.

4.2 The Bank is committed to ensure that its policies remain relevant and continue to meet the intended objectives and outcome. Accordingly, the Bank will review this policy document within five (5) years from the date of issuance or the Bank's last review and, where necessary, amend or replace this policy document.

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;

"**board**" refers to the board of directors of a licensed person;

"**licensed person**" refers to a takaful operator and a professional retakaful operator;

"**Participants' Individual Fund**" or "**PIF**" refers to a takaful fund established to allocate a portion of a takaful participant's contributions for the purpose of investment or savings;

"**Participants' Risk Fund**" or "**PRF**" refers to a takaful fund established to pool a portion of a takaful participant's contributions for the purpose of meeting takaful claims associated with events or risks specified in the takaful certificate;

"**PIF Investment**" refers to a takaful fund established for the purpose of investment where the principal amount is not protected and risk from investment is borne by the individual takaful participant. For an investment-linked takaful, PIF Investment shall refer to the unit fund(s);

"**PIF Savings**" refers to a takaful fund established for the purpose of savings where the principal amount is protected;

"**senior management**" refers to the chief executive officer and senior officers of a licensed person;

"**Shariah committee**" refers to the Shariah committee of a licensed person; and

"**additional takaful fund**" refers to creation of PRFs or PIFs in addition to the minimum requirement for the establishment of PRF and PIF.

5.3 A glossary of Arabic terminologies used in this policy document is set out in Appendix 1.

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 This policy document will supersede the following policy documents:
(a) *Guidelines on Takaful Operational Framework* issued on 26 June 2013;
(b) Paragraphs 2.1, 2.2 and 2.3 of *Guidelines on Family Takaful Products* issued on 12 July 2007; and
(c) Paragraph 9.1(d) of *Introduction of New Products by Insurers and Takaful Operators* issued on 15 May 2015.

PART B POLICY REQUIREMENTS

8. Establishment of operational framework

S 8.1 The board has the overall responsibility of promoting effective management of takaful operations to support a licensed person's business and risk strategies. In fulfilling this role, the board must approve an operational framework governing the management of takaful operations that comply with Shariah and promote sustainable takaful operations.

S 8.2 In relation to paragraph 8.1, the senior management of a licensed person must ensure that the scope of the operational framework is adequate to support effective implementation of takaful operations. The operational framework must take into consideration the nature and complexity of the takaful business, types of funds being managed and relevant Shariah contracts adopted in managing the takaful business. In this regard, the operational framework must include at minimum policies and procedures on –

(a) application of Shariah contracts;
(b) establishment and maintenance of takaful funds (including additional takaful funds) and shareholders' fund;
(c) product design and pricing;
(d) management of underwriting;
(e) management of retakaful;
(f) management of investments;
(g) management of claims;
(h) remunerations for management of takaful funds;
(i) management of operating costs;
(j) management of surplus in Participants' Risk Fund (PRF); and
(k) management of deficiency and loss rectification.

S 8.3 In relation to paragraph 8.2(a), the policies must at minimum –

(a) provide for the underlying Shariah principle of mutual assistance among takaful participants;
(b) clearly set out the contractual relationship between a licensed person and the pool of takaful participants; and
(c) clearly set out the contractual relationship between a licensed person and individual takaful participants, where relevant.

S 8.4 The senior management must ensure that the policies on Shariah contracts adopted in the operational framework required under paragraph 8.2 including the terms and conditions in the relevant legal documentations, are endorsed by the Shariah committee. For the avoidance of doubt, a licensed person must seek the Bank's written approval before adopting any Shariah contract in which the Shariah Advisory Council of the Bank (SAC) has not issued a ruling permitting its use.

S 8.5 In regard to the profit distributable from Participants' Individual Fund (PIF) or surplus distributable from PRF in relation to paragraphs 8.2(h) and (j) respectively, the policies must clearly specify that the proposed distributable amount, if any, must be approved by the board.

S 8.6 The senior management has the responsibility to ensure effective implementation of the operational framework and therefore must also have in place adequate internal systems and resources, which include –
(a) reliable infrastructure and information technology system;
(b) adequate human resources with relevant skills and competencies;
(c) appropriate internal controls systems; and
(d) a clear communication plan of the policies and procedures to all parties involved in the day-to-day management of takaful operations.

S 8.7 The senior management must ensure appropriate documentation is maintained for all aspects of the operational framework.

S 8.8 The senior management must conduct periodic reviews of the operational framework to ensure that it continues to remain relevant. Any material changes to the operational framework must be approved by the board and be made available to the Bank upon request.

Question 1
Are the requirements relating to Shariah contracts specified in this ED sufficiently comprehensive to strengthen the conduct of takaful operations? If no, please provide suggestions with clear justification.

9. Establishment and maintenance of takaful funds

S 9.1 Section 91 of the IFSA requires that a licensed person establishes general takaful funds or family takaful funds separate from its shareholders' funds.

S 9.2 As takaful funds are owned by takaful participants, section 92 of the IFSA also requires for a licensed person to ensure that the funds are established and managed in a manner that preserve the interest of the takaful participants at all times.

S 9.3 Accordingly, a licensed person must put in place internal policies and procedures governing the establishment of the takaful funds which must include –
(a) the establishment of PRF[1] under the general takaful funds and family takaful funds;
(b) where relevant, the establishment of a PIF for the purpose of investment (PIF Investment) under the family takaful funds;
(c) where relevant, the establishment of a PIF for the purpose of savings (PIF Savings) under the general takaful funds or the family takaful funds; and
(d) where relevant, the creation of PRFs or PIFs in addition to the minimum requirements for the establishment of funds as specified in paragraphs 9.3(a)-(c).

[1] Under *tabarru`* contract, PRF is collectively owned by the pool of takaful participants as deliberated in SAC's decision in its 62nd and 165th meeting.

S 9.4 In relation to paragraph 9.3(a), a licensed person carrying on family takaful business must maintain PRF for annuity takaful certificates separate from PRF for non-annuity takaful certificates.

S 9.5 In relation to paragraph 9.1, a licensed person must maintain general takaful funds or family takaful funds for its Malaysian takaful certificates separate from the foreign takaful certificates.

S 9.6 Notwithstanding paragraph 9.5, a licensed person may, with the prior written approval of the Bank, maintain a single general takaful fund or family takaful fund for its Malaysian and foreign takaful certificates subject to –
- (a) for general takaful business, the gross contributions in respect of foreign takaful certificates not exceeding RM5 million or 5% of total gross contributions, whichever is lower; or
- (b) for family takaful business, the total family takaful funds in respect of foreign takaful certificates not exceeding RM5 million or 5% of the total takaful protection[2] fund, whichever is lower.

Creation of additional takaful funds

S 9.7 In relation to paragraph 9.3(d), a licensed person creating additional takaful funds must set out in the internal policy –
- (a) the objective/purpose of establishing and maintaining the additional takaful funds;
- (b) the investment and risk strategies of the additional takaful funds;
- (c) a process to assess performance of the additional takaful funds and its long-term sustainability; and
- (d) arrangements to report to the board and relevant stakeholders on paragraphs 9.7(a)-(c).

S 9.8 In relation to paragraph 9.7(a), a licensed person in creating an additional takaful fund must consider –
- (a) different pricing methodology adopted for a specific type of takaful product due to business consideration or market practices;
- (b) nature of the risks, which can affect the pattern and predictability of claims; and
- (c) different surplus distribution method.

S 9.9 A licensed person must notify the Bank in writing not later than 30 days after the board approved any creation of an additional takaful fund.

S 9.10 The Bank, based on its assessment, reserves the right to require a licensed person to create additional takaful funds.

Management of takaful funds

S 9.11 A licensed person must manage each takaful fund and additional takaful fund separately from each other. In the case of PRF and additional PRF, a licensed person must ensure –

[2] Covers takaful business of non-annuity certificates, i.e. ordinary family takaful and investment-linked takaful.

(a) the PRF and additional PRF are managed separately from each other throughout the term of the takaful certificates, including when determining surplus and deficit; and
(b) any surplus of the PRF or additional PRF is utilised only for the respective PRF or additional PRF. Any cross-subsidisation of surplus between such funds is not allowed.

S 9.12 In relation to paragraph 9.11, a licensed person must have in place proper accounting and other relevant systems to ensure that assets, liabilities, income and expenditure are properly accounted for under the respective funds or additional takaful funds.

Consolidation of additional takaful funds

G 9.13 In relation to paragraph 9.7, a licensed person may consolidate any established additional takaful funds where the licensed person in its assessment has concluded that the consolidation will improve the long-term sustainability of the takaful funds and benefit takaful participants.

S 9.14 A licensed person must seek the board's approval for any consolidation of the additional takaful funds.

S 9.15 The senior management's proposal to consolidate the additional takaful funds for the board's consideration must include at minimum the following:
(a) assessment on sustainability of the takaful funds to meet future claims;
(b) assessment on the impact of the consolidation on the fair treatment to takaful participants, for example in terms of surplus distribution;
(c) confirmation that the affected additional takaful fund has no outstanding *qard*; and
(d) a summary of the appointed actuary's assessment on the impact of the consolidation on the financial condition of the takaful funds and the interests of takaful participants, and recommendations, if any.

S 9.16 A licensed person must notify the Bank in writing not later than 30 days after the board approved any consolidation of additional takaful funds.

Question 2

(a) Does your institution foresee any implementation issues in relation to the application of Shariah contract for the establishment of the following funds:
(i) PIF Savings for family takaful business;
(ii) PIF Savings for general takaful business; and
(iii) PIF Investment for general takaful business.
Please justify your response.
(b) What are the scenarios or circumstances that may lead to possible consolidation of additional takaful fund as envisaged in paragraph 9.13? In such cases, how do you manage best interest of takaful participants?
(c) What are your views on the need to create an additional PRF for group takaful products?
(d) Do you agree if the creation of an additional PRF for group takaful product should be mandated to ensure equitable surplus distribution? Please provide justification for your response.

10. Product design and pricing

S 10.1 A licensed person must design takaful products in accordance with the applicable Shariah contracts. In applying these contracts, a licensed person must observe the requirements specified in the policy documents on Shariah standards and operational requirements issued by the Bank.

S 10.2 A licensed person must ensure that a takaful product is designed and priced in line with the requirements specified in the policy document on *Introduction of New Products by Insurers and Takaful Operators.*

Product design

S 10.3 A licensed person must incorporate at minimum the following in its product design:
- (a) a *tabarru'* element for family or general takaful products;
- (b) where relevant, a savings element for family or general takaful products; and
- (c) where relevant, an investment element for family takaful products.

G 10.4 In relation to paragraph 10.3(a), the main takaful benefits payable from PRF may include, but are not limited to the following:
- (a) benefits to cover for financial loss or misfortune arising from specified events;
- (b) survival or maturity benefits;
- (c) surplus sharing from PRF;
- (d) payment arising from surrender of takaful certificate; or
- (e) cash payout benefit.

G 10.5 A licensed person may include additional takaful benefits from PRF which shall be a supplementary to the main takaful benefits as specified in paragraph 10.4.

S 10.6 A licensed person must ensure that –
- (a) takaful benefits, including additional takaful benefits payable from PRF are fully consistent with Shariah and objective of takaful; and
- (b) events leading to the payment of takaful benefits are pre-agreed by the takaful participants.

G 10.7 A licensed person may offer additional takaful benefits payable from the shareholders' fund to the takaful participants in the form of a *hibah* and shall be a supplementary to the main takaful benefits as specified in paragraph 10.4.

G 10.8 In relation to paragraphs 10.3(b) and (c), a licensed person may include a partial cash withdrawal option from the PIF Investment or PIF Savings as part of the takaful product design.

S 10.9 In the case where takaful participants are allowed to make a partial cash withdrawal, the licensed person must –
- (a) clearly disclose the withdrawal option and the terms and conditions for withdrawal in the takaful certificate;

(b) conduct a sustainability test prior to withdrawal to ensure that the withdrawal is not detrimental to the individual takaful participant's future takaful benefits, and that the future takaful contributions in the PIF are sufficient to cover *tabarru`* and any other charges throughout the term of takaful certificate. The results of the sustainability tests must be disclosed and communicated to the takaful participants; and

(c) ensure withdrawal charges, if any, are justified in accordance with the direct costs in managing the partial cash withdrawal.

G 10.10 Pursuant to paragraph 10.3(c) and the *Guidelines on Investment-linked Insurance/Takaful*, a licensed person may provide an injection of seed money from the shareholders' fund to assist in the establishment of the PIF of an investment-linked fund.

S 10.11 In providing the seed money, a licensed person –

(a) adopting *musyarakah* (joint venture) must specify the profit sharing ratio based on the proportion of its capital contribution; and

(b) adopting *qard*[3] and *wakalah* must not make the placement of seed money conditional to the agreement entered between the licensed person and the takaful participant.

Legal documentation

S 10.12 A licensed person must ensure that the terms and conditions stipulated in the legal documentation of takaful product fulfil the requirements of the adopted Shariah contracts and are enforceable.

S 10.13 In relation to paragraph 10.12, where applicable, the legal documentation shall clearly stipulate the terms and conditions associated with the application of Shariah contracts in a takaful product which include the following:

(a) ***tabarru`***[4]

(i) a statement that the *tabarru`* takes into effect when a takaful participant contributes to the PRF[5];

(ii) a statement that the PRF is collectively owned by the pool of takaful participants;

(iii) rates or amount of *tabarru`* and its frequency;

(iv) a statement that *tabarru`* rates or amount shall be agreed at the inception of the contract and shall not be revised without the consent of takaful participants; and

(v) types and amount of benefits payable from PRF.

(b) ***wakalah***

(i) description of the subject matter or task to be delegated by takaful participants to the licensed person;

(ii) details of the agreed *wakalah* fees as follows:

(1) types of fees and the corresponding tasks or services to be undertaken;

[3] This *qard* arrangement refers to the licensed person shareholders' fund as the lender.
[4] Refer to the SAC resolution in its 164th meeting.
[5] PRF may also be known as *tabarru`* fund.

(2) basis in determining fees, for example as a percentage of the contribution; and
(3) timing in which fees shall be paid (for example fees is taken upfront upon payment of takaful contributions);

(iii) circumstances that would be deemed as mismanagement or negligence by the licensed person and remedial action that will be undertaken accordingly;

(iv) a statement that under PIF Investment based on *wakalah bil al-istithmar* (agency contract for investment), a licensed person shall not guarantee the principal amount; and

(v) conditions for dissolution of the *wakalah*, which includes -
(1) circumstances in which the contract will be dissolved; and
(2) treatment of the *wakalah* fees in the events of the dissolution.

(c) ***mudarabah***
(i) profit or surplus sharing ratio; and
(ii) a statement that for PIF Investment, a licensed person shall not guarantee the principal amount.

(d) ***qard* for PIF Savings**
(i) amount of takaful contributions allocated for *qard*;
(ii) a statement that principal amount is guaranteed by a licensed person;
(iii) specified event for *qard* payment, for example payable upon maturity of takaful certificate; and
(iv) a statement that returns from investment of *qard*, if any, is at discretion of a licensed person.

(e) ***hibah***
(i) amount and criteria of *hibah* to be given; and
(ii) a statement that *hibah* is given at discretion of a licensed person.

Infrastructure supporting product design

S 10.14 For products with PIF where apportionment of *tabarru`* from PIF to PRF is made on a periodic basis, a licensed person must have in place accounting and other relevant systems that are –
(a) capable of precisely allocating the amount of takaful contributions to the respective takaful funds; and
(b) able to identify the amount of PIF of each individual takaful participant at any point of time.

Product Pricing

S 10.15 In determining the pricing of takaful products, a licensed person must –
(a) exercise prudence and due care to ensure the price of the takaful product is appropriate and reasonable;
(b) ensure adequate *tabarru`* allocation into the PRF to cover risks and obligations associated with the takaful certificate;
(c) ensure that the takaful contributions charged is sufficient to cover the *tabarru`* throughout the term of the takaful product; and
(d) consider future market fluctuations and uncertainties.

Question 3
Other than those specified in paragraph 10.9, what additional conditions would you consider appropriate for the purpose of offering partial cash withdrawal option?

11. Underwriting of takaful risks

S 11.1 A licensed person must manage underwriting effectively to avoid adverse selection[6] and to ensure that takaful funds are sustainable in the long run.

S 11.2 In relation to paragraph 11.1, a licensed person must have in place an underwriting policy which includes –
(a) parameters for takaful risk evaluation;
(b) categorisation of takaful risks;
(c) types of takaful risks that can be accepted in the takaful funds; and
(d) circumstances under which further investigation or documentation is required prior to acceptance of takaful risks.

S 11.3 In evaluating the takaful risks, a licensed person shall ensure that the –
(a) takaful risks to be accepted are consistent with the licensed person's underwriting capacity;
(b) takaful risks to be accepted are in line with the assumptions used in determining the pricing of the takaful product; and
(c) rating differentials (such as takaful contributions loadings), benefit exclusion or limitations on takaful coverage are applied when accepting takaful participants with higher risk profile.

12. Retakaful

S 12.1 A licensed person must establish a retakaful management strategy for selecting and monitoring retakaful arrangements.

S 12.2 In relation to paragraph 12.1, the licensed person must have in place policies and procedure for selecting and monitoring retakaful arrangements that include at minimum the following:
(a) the risk tolerance level of the takaful fund;
(b) the risk retention levels appropriate to the risk tolerance level of the takaful fund;
(c) the types of retakaful arrangements most appropriate to manage the risk exposure in relation to its risk tolerance;
(d) the process for selecting the panel of takaful and retakaful operators, which shall include considerations for diversification and financial strength of takaful and retakaful operators; and
(e) the process for monitoring, reviewing and updating the retakaful arrangement in response to changes in the market and the risk profile of the takaful funds.

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[6] Refers to tendency of individuals to participate in takaful arrangement where risks of these individuals to experience a loss are more likely than an average individual.

S 12.3 A licensed person shall only cede out takaful risks to another takaful operators or retakaful operators[7], be it another licensed person or a foreign institution.

S 12.4 Where takaful risks are ceded to a foreign takaful operator or retakaful operator, the licensed person must ensure that the foreign takaful operator or retakaful operator is conducting its business in compliance with Shariah.

S 12.5 A licensed person must not cede out[8] takaful risks to an insurer or reinsurer[9] except under unavoidable circumstances where the licensed person must demonstrate that –

(a) no takaful operator or retakaful operator is known to accept the particular risk;
(b) no takaful operator or retakaful operator has the capacity or expertise to accept the particular risk; or
(c) a retakaful arrangement with takaful operator or retakaful operator is possible, but has a potential detrimental effect on the takaful funds.

S 12.6 In relation to paragraph 12.5(c), a retakaful arrangement is deemed detrimental to the takaful funds where the takaful operator or retakaful operator is unable to meet its financial obligations towards the takaful funds, including where the takaful operator or retakaful operator is –

(a) not legally established in accordance with the laws of its home regulator;
(b) not properly regulated or supervised by its home regulator;
(c) not managed by a competent board and senior management;
(d) not financially strong, as may be evidenced by its financial statements or financial rating; or
(e) based in a country that is experiencing political or financial instability which has the potential to affect the takaful operator, retakaful operator or industry.

S 12.7 In the event a licensed person cedes out takaful risks to an insurer or reinsurer under the circumstances specified in paragraph 12.5, a licensed person shall observe the corresponding requirements in paragraph 12.6 in selecting a suitable insurer or reinsurer.

S 12.8 A licensed person must not accept reinsurance inwards from an insurer or reinsurer except for risk that is permissible under Shariah and the inward arrangement is based on a retakaful contract between the licensed person and that insurer or reinsurer.

S 12.9 The senior management of a licensed person must, in demonstrating that all possible efforts have been made to establish that the conditions specified in paragraph 12.5 (for cession to insurer or reinsurer) or paragraph 12.8 (for accepting inwards reinsurance) have been met, provide factual evidence of each proposed cession[10] for the board's approval and Shariah committee's

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[7] For paragraph 12, this includes licensed takaful operator and professional retakaful operator.
[8] Refer to the SAC resolutions in its 113th and 114th meeting.
[9] For paragraph 12, this includes licensed insurer and professional reinsurer.
[10] Including cession to insurer or reinsurer upon renewal of reinsurance contract.

endorsement. The licensed person must document the justification and factual evidence supporting the cession to insurer or reinsurer.

S 12.10 Where the contractual period for cession to insurer or reinsurer extends beyond one year, the licensed person must conduct annual review to ensure that the basis supporting each cession in relation to paragraph 12.9 is still relevant.

S 12.11 In line with the concept of mutual assistance and collective ownership of the retakaful PRF[11] a licensed person must ensure that any form of performance-based payment to a cedant of a retakaful arrangement from the retakaful PRF shall only be made based on the overall performance of the fund.

S 12.12 A licensed person must ensure that any commission, profit-sharing or performance-based payments arising from the retakaful arrangement are fairly redistributed to the relevant funds taking into consideration the source of the retakaful contributions and the performance of the funds leading to such payment.

S 12.13 A licensed person must monitor, review and update the retakaful management strategy on a regular interval in response to changes in the takaful funds' risk profiles.

Question 4

(a) What are other considerations adopted by your institution's and assessment process undertaken to allow for ceding out/in to insurer or reinsurer in addition to those specified in paragraphs 12.5 and 12.8? Please also highlight the basis of Shariah decision for such practices.

(b) If pricing or potential loss of business is not construed as unavoidable circumstances for the purpose of paragraph 12.5, what are the implications that your institution can foresee from such requirement? Please provide clear justification.

13. Investment of takaful funds

S 13.1 A licensed person must manage the investments of takaful funds in a sound and prudent manner, in line with Shariah requirements and takaful participants' reasonable expectations as specified in the *Guidelines on Investment Management for Takaful Operators*.

S 13.2 A licensed person must have in place effective information technology system to support the investment management of the takaful funds. In this regard, the system must be able to –

(a) earmark specific investments to the relevant funds; and

(b) precisely determine and account for the distribution of investment profits accrued to individual takaful participants and the licensed person for PIF Investment.

[11] Refer to the SAC resolution in its 134th meeting.

S 13.3 For a product with PIF Investment, a licensed person must ensure that the policy on investment management includes a method for calculating investment profits and that method is applied consistently for all takaful certificates with PIF Investment throughout the financial year.

S 13.4 In managing investments, a licensed person may conduct cross trading between the funds, including with an affiliated licensed persons. This is subject to the licensed person establishing clear policies and procedures to govern the conduct of cross trading between the funds as to ensure the sustainability of both takaful funds and that the best interest of takaful participants is preserved. The policies and procedures must specify at minimum the –

(a) trading and investment objective and strategy;
(b) type of Shariah-compliant investment assets[12] which can be cross traded;
(c) process for executing cross trade which shall be conducted at arm's length[13] and on a fair value basis[14];
(d) control and monitoring mechanism; and
(e) escalation process and information disclosure to the board which include assessment on the impact of cross trade on takaful funds and participants.

S 13.5 Pursuant to paragraph 13.4, a licensed person must ensure that an independent review is conducted at least annually by persons with sufficient expertise and relevant experience, to provide the board with an assessment on compliance to the cross trading policies and procedures, as well as the effectiveness of the cross trading activities in achieving the investment objectives.

14. Payment and charges on surrender of takaful certificate

S 14.1 A licensed person must determine the surrender value, including the cost of any applicable surrender charge, in a manner consistent with ensuring the fair treatment of takaful participants and in accordance with generally accepted actuarial principles.

S 14.2 A licensed person must ensure that the amount payable to participants upon surrender is made from the appropriate funds. For example, in relation to takaful product adopting *wakalah*, and where the surrender value is determined based on gross contribution basis, the surrender value shall include the amount of unexpired *wakalah* fees which shall be payable from the shareholders' fund.

S 14.3 In the case of single contribution for long-term cover takaful product that is allocated only in the PRF as *tabarru`*, the surrender value shall include the

[12] For avoidance of doubt, only Shariah-compliant investment assets are allowed for cross trading with conventional entities.

[13] Arm's length is when the price is determined if such transactions were made between independent entities under the same or similar circumstances (*Transfer Pricing Guidelines* by Lembaga Hasil Dalam Negeri).

[14] Fair value is defined as an amount of an asset that could be exchanged between knowledgeable and willing parties in an arm's length transaction (International Accounting Standard Board).

unexpired *tabarru`* amount and accrued surplus due to takaful participants in PRF, where applicable.

S 14.4 For a takaful product with PIF features, the surrender value shall include the balance of PIF and accrued surplus due to takaful participants in PRF, where applicable.

S 14.5 A licensed person may impose a surrender charge for the cancellation of takaful certificate. The surrender charge shall reasonably reflect the expected incurred expenses which have not yet been recouped by other charges levied up to the point of surrender. The surrender charge may also include administrative expenses incurred in processing the cancellation of certificate.

S 14.6 In relation to paragraph 14.5, a licensed person which inadvertently imposes a surrender charge greater than the expected incurred expenses to mitigate the risks of surrender for a particular takaful fund, must maintain that excess amount in the fund.

S 14.7 For general takaful products which are not subject to requirements under the policy document on *Introduction of New Product for Insurers and Takaful Operators*, a licensed person must document the computation for the cancellation basis and shall make it available to the Bank upon request.

15. Claims management

S 15.1 A licensed person must have in place internal policies, procedures, systems and controls to manage claims, in line with the requirements under section 142 of the IFSA for family takaful benefits and the *Guidelines on Claims Settlement Practices (Consolidated)* for general takaful benefits.

S 15.2 In the claim handling procedures, the licensed person must –
(a) assess the validity of claims and claims settlement amount; and
(b) ensure that the processing and payments of claims are done promptly.

S 15.3 Pursuant to paragraph 15.2(a), the licensed person must ensure that claims are paid from the relevant funds as stipulated in the takaful certificates.

S 15.4 A licensed person must establish appropriate measures to prevent fraudulent claims or payment of invalid claims.

16. Remuneration for the management of takaful funds

G 16.1 A licensed person may be remunerated in consideration for the services rendered, costs incurred and performance outcome in managing takaful funds. Any such remuneration may include elements of fixed remuneration (i.e. upfront *wakalah* fee), performance-based remuneration and compensation for direct costs incurred. Regardless, the remuneration shall be made in accordance with the requirements of the relevant Shariah contract.

S 16.2 A licensed person must have in place a remuneration policy which ensures that –

(a) the remuneration is structured such that the level of remuneration is aligned with the outcome of work undertaken in managing takaful funds;

(b) the remuneration level is commensurate with the nature, scope, complexity of the work undertaken in managing the takaful funds; and

(c) the remuneration is consistent with prudent risk-taking, preserves the interest of the takaful participants and ensures the long-term sustainability of the takaful funds

S 16.3 In relation to paragraph 16.2(a), any work undertaken must be accounted for or charged only once in any of the remuneration as specified under paragraph 16.1.

S 16.4 For general takaful products which are not subject to the requirements as specified under *Introduction of New Product for Insurers and Takaful Operators* policy document, a licensed person must document the approach and justification of the remuneration for such product and ensure that the documents are made available to the Bank upon request.

Upfront *wakalah* fee

G 16.5 A licensed person adopting the *wakalah* contract may be remunerated based on a fixed upfront fee which may be charged as a percentage of the takaful contributions.

S 16.6 The upfront *wakalah* fee must be used to cover mainly for the commissions and management expenses incurred in managing the takaful funds. Any residual margin in the *wakalah* fee intended for profits must be reasonable and appropriate.

S 16.7 Where *wakalah* is arranged with PIF Savings based on *qard*, a licensed person must ensure that the upfront *wakalah* fee as a percentage of the takaful contribution is determined after deducting the value of *qard* from the takaful contribution[15] and the remuneration for managing the PIF Savings shall be in accordance with paragraph 16.18.

Surplus sharing

G 16.8 A licensed person adopting the *wakalah*[16] or *mudarabah* contract may be remunerated based on the performance outcome of the PRF.

S 16.9 In relation to paragraph 16.8, the remuneration shall be determined based on a proportion of the distributable surplus in PRF or a proportion of the component of the distributable surplus in PRF, as specified in paragraph 18.3.

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[15] Refer to the SAC resolution in its 137th meeting.

[16] This is considered as an incentive fee for managing the PRF to be in surplus position in line with policy document on *Wakalah*.

S 16.10 In relation to paragraph 16.9, a licensed person must ensure that –

(a) the shareholders' portion of the surplus is only distributed to shareholders provided that the takaful participants' portion of the surplus has been paid or accrued[17] to the takaful participants;

(b) the total amount of surplus payable to the licensed person must not exceed the amount of surplus paid or accrued to the takaful participants; and

(c) remuneration is in line with the licensed person's policy on surplus management and the requirements as specified in paragraph 18.

G 16.11 In relation to paragraph 16.10(b), a licensed person adopting the *mudarabah* contract may submit the application to the Bank to apply to vary the amount of the distributable surplus. Such an application must be sufficiently justified and endorsed by the Shariah committee, and approved by the board.

Fee on risk fund or *tabarru`*

G 16.12 A licensed person adopting the *wakalah* contract may be remunerated based on the proportion of the takaful contributions allocated to the PRF in the form of fee on risk fund or *tabarru`.*

S 16.13 The fee on risk fund must be maintained in the PRF and shall not be distributed to the licensed person unless the following conditions are fulfilled:

(a) PRF[18] is in surplus position as determined under paragraph 18.3(a);

(b) the quantum of the distributable fee must be recommended by the appointed actuary based on the requirements stipulated in paragraph 18.4; and

(c) the distribution of the fee is in conformance to the requirements of paragraph 16.10. For purposes of meeting requirements in paragraph 16.10(b), the fee to be distributed as income shall form part of the total amount of remuneration from PRF.

S 16.14 Pursuant to paragraph 16.13, a licensed person shall not carry forward the fee that is not distributed to the licensed person for a particular financial year to the subsequent financial year.

Profit sharing

G 16.15 A licensed person adopting the *wakalah bil al-istithmar* (investment agency) or *mudarabah* contract may be remunerated based on the agreed profit-sharing ratio from the return on investment or investment profit.

G 16.16 For investment-linked family takaful products adopting the investment agency contract, remuneration may take the form of fund management fee and may be determined based on the net asset value of the PIF Investment subject to

[17] Accrued surplus refers to surplus that is declared to individual participants but not yet transferred out of the PRF. The accrued surplus becomes a liability of the PRF and will be paid to takaful participants at a pre-determined time as per the takaful contract.

[18] Requirement in paragraph 16.13(a) does not apply to fees charged on *tabarru`* for unit-deducting riders (i.e. riders for which no explicit contributions has been paid or priced upfront), in consideration of work undertaken by the licensed person which has not been factored into the determination of other fees.

the limits as specified in the *Guidelines on Investment-Linked Insurance/Takaful Business.*

S 16.17 For the distribution of investment profit from PIF Investment, a licensed person must ensure –

(a) the profit is determined based on the financial accounts of the licensed person that have been fully audited by an external auditor and upon completion of a full valuation of PRF liabilities by the appointed actuary;

(b) the amount of investment profit to be distributed must be recommended by the appointed actuary;

(c) the distribution of investment profit does not affect the future ability of PIF Investment to meet the *tabarru`* apportionment to PRF;

(d) the amount to be distributed is within the profit-sharing ratio stated in the takaful certificate; and

(e) due consideration is given to takaful participants' reasonable expectation when recommending the distribution of PIF investment profit.

Compensation for direct costs

G 16.18 In managing PIF Savings based on *qard*, a licensed person may be remunerated based on the compensation for the direct costs incurred.

S 16.19 In relation to paragraph 16.18, a licensed person must have in place appropriate policies and procedures for identifying the eligible actual or estimated direct costs.

Question 5

(a) Does your institution set fees on risk fund or *tabarru`*? Please also comment on its relevancy given that the ED allows licensed persons to share the distributable surplus of PRF.

(b) What would be the implications to your institution if the Bank were to disallow takaful operators to be remunerated based on fee on risk fund?

17. Management of operating costs

Operating costs incurred by shareholders' fund

S 17.1 A licensed person must ensure that operating costs of takaful operations are paid from the shareholders' fund through the remunerations received as specified in paragraph 16.

S 17.2 The operating costs shall include commissions, related expenses payable to the distribution channels, management expenses and other operational expenses.

S 17.3 A licensed person must establish effective controls to ensure actual expenses incurred by the shareholders' fund do not lead to cost overruns which can affect the viability of the licensed person and would have a negative impact on their ability to manage the takaful funds effectively.

S 17.4 A licensed person must ensure that the remuneration received under paragraph 16 is prudently managed to cover operating costs incurred in managing the takaful funds for the full contractual obligation of the takaful certificate. In this regard, a licensed person must establish appropriate and adequate provisions to meet the expense liabilities of the shareholders' fund as specified in the *Guidelines on Valuation Basis for Liabilities of Family Takaful Business* or *Guidelines on Valuation Basis for Liabilities of General Takaful Business* to ensure all remuneration received are sufficient to meet the operating costs incurred.

Expenses charged to takaful funds

S 17.5 A licensed person must not pay expenses out of the takaful funds except for –
(a) direct claims-related expenses which refers to fees or costs directly associated with settling claims such as adjustor's and legal fees; and
(b) direct investment-related expenses which refers to the transaction costs directly attributable to the acquisition, issuance or disposal of a financial asset of the takaful funds.

S 17.6 In relation to paragraph 17.5, a licensed person must ensure that –
(a) amount charged to the takaful funds is limited to the actual amount of expenses incurred; and
(b) expenses incurred are not factored into the determination of any forms of remuneration to the licensed person.

G 17.7 Where expenses charged to the takaful funds are deemed inappropriate, the Bank may require a licensed person to apply retrospective adjustments to the takaful funds and to repay the expenses.

18. Management of surplus in PRF

S 18.1 A licensed person must manage the operations of takaful funds to ensure that the funds' experience is within that assumed in the pricing of takaful products.

S 18.2 A licensed person must have in place a policy to manage surplus in PRF which –
(a) outlines the manner in which surplus is utilised, including surplus distribution and the level of surplus to be retained to cushion future volatilities in experience of the PRF;
(b) requires that the surplus in PRF is managed in such a way as to preserve the long-term viability of the PRF;
(c) requires that the surplus in PRF for the takaful fund and where applicable, the additional takaful fund, is managed separately from each other; and
(d) specifies the method in which surplus is to be distributed to the takaful participants.

S 18.3 For distribution of surplus in PRF, a licensed person must ensure that the –
(a) surplus is determined –
(i) based on a full valuation of liabilities, certified by the appointed actuary and the financial accounts of the licensed person that are fully audited by an external auditor;
(ii) only after claims and other outgo of the fund such as retakaful contributions being met;

(iii) only after observing any other prudential requirements specified by the Bank; and
(iv) based on generally accepted actuarial principles and is in a manner which ensures fair treatment of different groups of takaful participants;

(b) surplus to be distributed is recommended by the appointed actuary;
(c) surplus distribution is in line with the policy as specified in paragraph 18.2 and the underlying Shariah contract;
(d) surplus distribution is made subject to there is no deficit as defined in paragraph 19.1; and
(e) surplus distribution will not create adverse financial implications on the PRF or result in a deficit in the PRF.

S 18.4 In relation to paragraph 18.3(b), in determining the amount of surplus to be recommended for distribution, the appointed actuary must –

(a) assess the strength of the takaful funds to ascertain the extent to which it would be appropriate for surplus to be distributed such that the long-term sustainability of the funds is not affected; and
(b) refrain from recommending the distribution of surplus if in the appointed actuary's professional judgment, the surplus should remain in the PRF as a buffer to maintain the ability of the takaful funds to meet future liabilities or to meet takaful participants' reasonable expectations that are not specifically provided for in the actuarial valuation.

S 18.5 A licensed person must ensure that the distributable surplus to the shareholders' fund is transferred to the shareholders' fund and not retained or accumulated in the PRF.

G 18.6 Pursuant to 18.2(d), the method for distributing surplus to takaful participants may include, but need not be limited to, the following:

(a) retain the distributable surplus in PRF, where the amount shall be made available and to be paid upon claim, maturity or surrender;
(b) accumulate the distributable surplus in PIF Investment or Savings of the individual takaful participants and payable upon claims, maturity or surrender;
(c) pay the distributable surplus directly to the bank account of each individual takaful participant; or
(d) donate to charitable organisation, in the case where takaful participants agree to forgo their rights to the distributable surplus.

S 18.7 In relation to paragraph 18.6, the surplus distribution method shall be clearly stipulated in the takaful certificates.

19. Deficiency and loss rectification

Deficiency and loss in PRF

S 19.1 A deficit in the PRF occurred when assets of the PRF are insufficient to meet the liabilities of the PRF, where assets and liabilities refer to the total assets of the PRF and the sum of actuarial liabilities and other liabilities[19] of the PRF, respectively, as reported in the balance sheet of the takaful funds.

S 19.2 Where there is a deficit in the PRF, a licensed person must immediately rectify the deficit via *qard*[20] from the shareholders' fund.

S 19.3 A licensed person must ensure that the *qard* is repaid from excess of assets over liabilities as defined in paragraph 19.1 arising in the PRF in the future years.

G 19.4 Notwithstanding paragraph 19.3, a licensed person may provide financial support in the form of *hibah* to rectify the deficiency in PRF by way of actual transfer of the assets from the shareholders' fund to the PRF.

S 19.5 A licensed person must have in place a policy to rectify any deficiency which shall include at minimum, the following:

(a) the manner in which the *qard* provided by shareholders will be repaid. The repayment of *qard* must take into account the ability of the PRF to meet future liabilities and takaful participants' reasonable expectations;

(b) the manner in which the surplus will be distributed to takaful participants during the period where *qard* has not been fully repaid by the PRF, for example, whether the distribution of surplus shall be continued, reduced or put on hold;

(c) the time period over which *qard* shall be repaid. *Qard* shall be deemed irrecoverable beyond the specified time period; and

(d) the circumstances under which the *qard* is not repayable.

S 19.6 In relation to 19.5(c), in determining the time period to repay *qard*, a licensed person must take into account the following:

(a) likelihood of *qard* being repaid over the foreseeable future;

(b) the expected future experience of the PRF in generating a surplus; and

(c) the potential adverse impact to the viability of the PRF should the *qard* persist.

G 19.7 Notwithstanding paragraph 19.5(c), the Bank may require a licensed person to write-off the *qard* prior to the time period specified by the licensed person over which *qard* shall be repaid.

S 19.8 In the event that there is a deficit or loss in the PRF due to mismanagement or negligence, a licensed person must immediately rectify the deficit or loss through an outright transfer of assets from the shareholders' fund.

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[19] The amount of "other liabilities" less the amount of qard outstanding.

[20] Refers to the contract where the licensed person (shareholders' fund) acts as the lender of money and PRF as the borrower.

S 19.9 Pursuant to paragraph 19.8, a licensed person must explain and provide sufficient information to the Bank on the following:
(a) reasons for the deficit or loss;
(b) remedial measures to avoid recurrences of deficit or loss and the expected duration to implement such measures; and
(c) implications of the deficit or loss to the takaful participants.

G 19.10 Where the Bank assesses that the deficit or loss is due to mismanagement or negligence, the Bank may require a licensed person to rectify the deficit or loss in the PRF through an outright transfer of assets from the shareholders' fund.

Deficiency and Loss in PIF Investment

S 19.11 A licensed person must ensure sufficient and relevant information are disclosed to takaful participants to facilitate their understanding of market performance and its implications including potential shortfall of the PIF Investment and possibility of takaful certificate to lapse.

S 19.12 Where the deficiency and loss in the PIF Investment is due to mismanagement or negligence, a licensed person must immediately rectify the loss through an outright transfer of assets from shareholders' fund.

G 19.13 In relation to paragraph 19.12, mismanagement and negligence may include, but not limited to, the following:
(a) poor disclosure of the investment risk borne by takaful participants;
(b) non-compliance with the investment strategy or improper execution against approved policies;
(c) investment strategy adopted by licensed person is inconsistent with the strategy that had been agreed with takaful participant at the point of entering into takaful certificate; and
(d) misleading information disclosed in the product disclosure sheet.

20. Other requirements

Assets of takaful funds

S 20.1 A licensed person must secure any documents evidencing the licensed person's title to assets of the takaful funds or any licensed professional retakaful operator's deposit held by the licensed person to meet liabilities of takaful funds.

S 20.2 The documents shall be kept in Malaysia in the custody of –
(a) the licensed person;
(b) a licensed Islamic bank or a licensed bank; or
(c) where for any special reason a document is kept in the custody of any other person on its behalf, the licensed person must notify the Bank in writing of that person and the reasons for his appointment as the custodian and of any change in that custody and the reason for it.

G 20.3 Notwithstanding paragraph 20.2, the documents –

(a) may be kept outside Malaysia in the custody of a person at such place with prior written approval from the Bank, subject to any conditions that may be specified; or

(b) may be kept in the custody of a takaful operator or a bank, in the country where the licensed person is carrying on business to the extent the assets relate to its business in that country.

S 20.4 Pursuant to paragraph 20.3(b), the licensed person must notify the Bank in writing of the custodian of its documents and the Bank may require the licensed person to produce a certificate from the custodian or its auditor verifying the existence of the documents.

S 20.5 A licensed person must not pledge, mortgage or charge any of the assets or securities of takaful funds or shareholders' fund except with the prior written approval from the Bank.

Liabilities of takaful funds

S 20.6 A licensed person must ensure that the valuation of takaful liabilities shall be determined as specified in the *Guidelines on Valuation Basis for Liabilities of General Takaful Business* or *Guidelines on Valuation Basis for Liabilities of Family Takaful Business*. In this regard, the licensed person must appoint a person with the appropriate qualifications and technical skills to conduct the valuation of its takaful liabilities as specified in the policy document on *Appointed Actuary*.

Registers of takaful certificates and claims

S 20.7 A licensed person must maintain a separate register for its Malaysian and foreign takaful certificates, and a separate register for takaful claims under its Malaysian takaful certificates and for claims under its foreign takaful certificates, as follows:

(a) information relating to takaful certificates and claims to be recorded in the registers shall include the information necessary for identification of the liabilities underwritten as well as the processing and validation of the liabilities and takaful claims against the takaful certificates, respectively; and

(b) information for register of takaful certificates shall be recorded upon issuance or transfer of the takaful certificates. Whereas for the register of takaful claims, the information shall be recorded upon the licensed person becomes aware of the takaful claims.

S 20.8 A licensed person must, at the request of any person having an interest in the takaful certificate or claim, inform that person whether the takaful certificate or claim is entered in the register.

S 20.9 A licensed person must keep the registers of takaful certificates and claims in Malaysia at all times and maintain these registers as long as the licensed person is under any liability in respect of any takaful certificates or claim registered.

Free-look period and advanced contributions

S 20.10 For takaful contributions received during free-look period, a licensed person must allocate the contributions in the PRF or PIF Savings.

S 20.11 Notwithstanding paragraph 20.10, in the event of cancellation of certificate by takaful participant during free-look period, a licensed person must return the full amount of takaful contributions to the takaful participants and this must be clearly stipulated in the takaful certificate.

S 20.12 In relation to paragraph 20.11, similarly, for takaful contributions received as advance takaful contributions[21], a licensed person must return the full amount of advance contributions to the takaful participants in the event of surrender or claims by the takaful participants and this must be clearly stipulated in the takaful certificate.

S 20.13 Where a takaful participant arranges for a takaful coverage directly[22], a licensed person must give rebates to the takaful participant in case where there is savings in acquisition costs[23].

Question 6

(a) Please highlight operational challenges to comply with proposals under paragraphs 20.10 to 20.12, if any.

(b) Please highlight any significant operational considerations and challenges that need to be addressed to ensure effective implementation of the ED within 6 months from the issuance date.

[21] Refers to a takaful contributions received by the licensed person for takaful certificate which have already been incepted but where the takaful contributions are not yet due for payment.

[22] E.g. walk-in, tele-marketing or electronic payment.

[23] Acquisition costs could have been priced in the takaful contributions although there is no or minimal acquisition costs incurred.

Appendix 1: Glossary for Arabic terminologies

Terms	Definition
Hibah	Transfer of ownership of an asset from a donor to a recipient without any consideration
Mudarabah	Profit-sharing contract
Musyarakah	Joint venture contract
Qard	Loan
Tabarru`	Donation
Wakalah	Agency contract
Wakalah bi al-istithmar	Agency contract for investment