

# FAQs for IFSB-11

## Standard on Solvency Requirements for *Takāful* (Islamic Insurance) Undertakings

**Q 1. Is it the case that the standard is a modification and adaptation of the International Association of Insurance Supervisors' (IAIS) regulatory capital requirements to cater for the specificities and characteristics of *takāful* undertakings (TUs)?**

Answer: Yes. The standard benefits from, and builds on, the established international frameworks set out by the IAIS. This approach is adopted in order to ensure that the supervision of *takāful* is established on sound regulatory principles, consistent with, and no less robust than, those established in conventional insurance.

**Q 2. The standard document sets forth seven key principles relating to the solvency requirements for TUs. What is the main goal of these principles?**

Answer: The main goal of these principles is to provide guidance to the supervisory authority in assessing a TU's solvency position, to ensure that the solvency levels of all participants' risk funds (PRFs) are consistent with their overall risk profiles, and to enable early intervention if the solvency buffer doesn't sufficiently cover the risks.

**Q 3. Is the standard applicable only to TUs?**

Answer: No. The standard is also applicable to *retakāful* undertakings. Its application can be extended to *takāful* "window" operations at the discretion of the supervisory authority.

**Q 4. What factors distinguish solvency assessment in TUs from that of conventional insurance?**

Answer: Unlike conventional insurance, the structure of a typical TU requires a clear segregation of the PRF from the *takāful* operator's (TO's) shareholders' funds. This structural difference accounts for the differences in the way solvency assessments are conducted by *takāful* and conventional insurance undertakings. Since the funds are segregated, solvency must logically be considered separately for each fund.

**Q 4. What are the components of funds in a typical TU, and the relevance of each fund regarding the solvency requirements of a TU?**

Answer: A typical TU comprises a two-tier structure: (i) a *takāful* PRF, which is the underwriting funds; and (ii) a TO's shareholders' fund. A family *takāful* business has an additional savings and investments component in the segregated fund, called the participants' investment fund (PIF). The standard places particular emphasis on the solvency requirements for a *takāful* PRF, which are the underwriting funds (i.e. an element of the business that is inherent in the underwriting activities, and the contributions to which are made on the basis of a *tabarru'* commitment) and, to some extent, a corresponding TO's shareholders' fund. However, the PIF is not taken into account in the assessment of the solvency requirements of a TU.

**Q 5. Does the standard recognise the impact of the *takāful* operational model in the solvency position of a TU's solvency?**

Answer: Paragraph 21 of the standard emphasises that the substance of Shari’ah rules and principles adopted in a jurisdiction or by TOs should govern the contracts as well as form the basis for an appropriate treatment in deriving their minimum solvency requirements. This statement may be considered in view of the fact that the type of *takāful* model in operation, and the remuneration derived therein by the TOs, may influence the position of the policyholders’ fund. In a *takāful* scheme, the operator may act as *wakil* in managing an underwriting fund and in turn is remunerated for these services with *wakala* fees. On the other hand, a TO may act as *wakil* for administering an underwriting risk fund (PRF) and be remunerated with a *wakala* fee for these services, and act as *mudarib* for administering the investment of the PRF with remuneration from a share of the investment income but not from the underwriting surplus. The *takāful* model adopted by a TU directly influences the position of its component funds and thereby determines how solvency assessments are performed given the two-tier structure of a TU.

**Q 6. How does a TU resolve the issue of providing a capital backing to a PRF to enable it to meet an initial solvency requirement or to alleviate solvency strain at a later date, since a PRF has little or no independent means of raising capital besides the participants’ contributions that are made on the basis of a *tabarru’* commitment?**

Answer: Capital of the shareholders’ fund may provide eligible capital to the PRF for regulatory purposes through a mechanism referred to as a *qard* facility. The *qard* facility is to be repaid out of future surpluses of the PRF.

**Q 7. What do you understand by the term “*qard* facility”?**

Answer: “*Qard* facility” refers to an arrangement of transferring otherwise surplus capital in the shareholders’ fund so that it may be counted towards the eligible capital resources of a PRF for solvency purposes. Such an arrangement must conform with local regulations and not violate the terms under which the assets are maintained and would be transferred.

**Q 8. What are the factors that a supervisor should take into account when determining the eligibility of the capital resources of a *qard* facility for the solvency purposes of a PRF?**

Answer: The following factors must be considered:

- a. Adequate, unencumbered capital must exist in the shareholders' fund in order for a facility of this nature to be effective.
- b. The TO must hold adequate capital in a suitable form, in addition to the solvency requirements of the shareholders’ fund.
- c. The terms on which a *qard* facility is made available must be considered in the light of the prevailing regulations, particularly those that determine the status of “outstanding” *qard* (i.e. a *qard* that has been made but not repaid) in the case where a PRF enters into an insolvent winding-up. In such a case, there are two possible scenarios: (i) Any outstanding *qard* would rank *pari passu* with participants’ claims, so that the deficiency would be shared pro rata; or (ii) participants’ claims would rank above any outstanding *qard*. Only in the second case should the *qard* facility be considered to be fully part of regulatory capital. In the first case, it might be considered as making some contribution to regulatory capital (see also paragraph 51).

### **Q 9. What purpose does valuation of assets and liabilities serve in the context of solvency assessment of TUs?**

Answer: Valuation of assets and liabilities is referred to as “valuation for solvency purposes”.<sup>1</sup> Solvency assessment is the application of supervisory judgment to various measures and estimates of a TU’s current and future financial position, which serve to demonstrate its ability to meet its policyholder obligations when they fall due. The valuation method determines the values a TO would place on its assets or liabilities, and this in turn highlights the importance of capital in a TU’s valuations and reporting.

Consistency in the valuation of assets and liabilities for solvency purposes does not necessarily imply that a single valuation basis is used for all assets and liabilities; rather, it is the application of principles that identify various features, including *takāful* liability measurement, risk margins and aspects of family *takāful* accounting.<sup>2</sup> As a result, the IASB’s IFRS-17 will influence the valuation of assets and liabilities and the overall accounting model for regulatory purposes, and this will provide a meaningful and economically sound representation of *takāful* companies and the industry to the markets.

### **Q 10. What are technical provisions?**

Answer: Technical provisions comprise two components: the current central best estimate of the *takāful* underwriting obligations (discounted to the net present value), and a risk margin. The valuation of liabilities is based on assumptions made about the future. *Takāful* liabilities (obligations)<sup>3</sup> may extend well into the future, depending on the nature of the business underwritten.<sup>4</sup> Naturally, there is a risk that the future will be significantly different from what has been assumed. This raises the question whether the financial assets backing the liabilities will suffice to meet all future obligations. TOs often reflect this in the risk margin in technical provisions that relate to all liability cash flows and thus to the full time horizon of the underlying *takāful* contracts. Each component of the technical provisions is determined on an arm’s-length basis in order to support generally the objectives of transparency and comparability.

### **Q 11. How should the assets backing the technical provisions be treated?**

Answer: The carrying values of assets would normally be fair values in accordance with the prescribed accounting/financial reporting standards, but the solvency margin reserve would include an amount to cover the risk of the realisable value being less than the carrying amounts. (If the carrying value is not in fact fair value, appropriate adjustments may be required to the solvency margin reserves.) TOs often endeavour to structure their investment portfolios so that cash flows from expected investment returns match the expected cash flow of future claims (cash flow matching).

### **Q 12. The key feature (1) in paragraph 27 stated that “the solvency requirements for *takāful* undertakings must adopt a total balance sheet approach to ensure that risks are appropriately recognised and consistently valued and to identify the interdependence between assets, liabilities, regulatory solvency requirements for PRF and the shareholders’ funds of the *takāful* operator.” What is the implication of this sentence?**

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<sup>1</sup> See the “Valuation and Capital Adequacy” section of the IAIS ICPs.

<sup>2</sup> IAIS considers it most desirable that the accounting standards in the ICP should be consistent with the financial reporting standards (IFRS).

<sup>3</sup> Liabilities are generally established upon issuance of the contract; they reflect the expected value of future obligations.

<sup>4</sup> Insurance is typically classified into two main categories: life insurance and non-life insurance.

Answer: This sentence emphasises the approach of the valuation of assets and liabilities for the purpose of assessing the capital requirements of a TU within the context of risk-based capital requirements. Valuation of a TU's assets and liabilities on a consistent basis means that differences in the values of assets and liabilities can be explained in terms of the differences in the nature of the cash flows, including their timing, amount and inherent uncertainty, rather than in terms of differences in methodology or assumptions. Such consistency may be applied at different levels, such as segments within a company, a company or a group. Ultimately, the aim is to match the duration of liabilities and financial assets (an investment portfolio), approximately if not perfectly, thus making asset–liability management (ALM) an important aspect of a TU's valuation.

Solvency assessment based on consistent valuation of assets and liabilities is a prerequisite for obtaining a meaningful insight into the asset–liability positions of a TU and an understanding of its financial position. The assessment of the financial position of a TU for supervisory purposes addresses its technical provisions, required capital and available capital resources. These aspects of solvency assessment (namely, technical provisions and capital) are intrinsically interrelated and cannot be considered in isolation by a supervisor. This is to ensure that risk is appropriately recognised and considered, originating from the two sides of the balance sheet in an integrated or interactive manner. Technical provisions and regulatory capital requirements are significant components of valuation for solvency purposes, in addition to a risk margin (a methodology that the International Actuarial Association [IAA] has explored in cooperation with IAIS).

Accordingly, the new framework for the measurement and reporting of insurance contracts – the IFRS standard on insurance contracts (IFRS-17) – is expected to ensure a greater consistency in the methodologies used for general purpose financial reporting and for reporting to the regulators for prudential purposes which may have as few changes as possible to satisfy prudential reporting requirements.

### **Q 13. How does the total balance sheet approach apply to a TU?**

Answer: The separation of funds into PRF and shareholders' funds is a fundamental characteristic of TUs. The standard highlights the fact that the “total balance sheet” approach to valuation of assets and liabilities can suitably be applied to the two-tiered structure of TUs. The valuation of assets and liabilities will be performed accordingly in each fund, and each fund should separately have sufficient assets to meet its solvency requirements. This also illustrates that the solvency assessment of TUs recognises Shari'ah rules and principles as the basis for deriving minimum solvency requirements. This rule is of critical importance, particularly to ensure clarity regarding the position of funds and the transparency of any cross-subsidy. Of particular concern are situations where participants' funds are in persistent deficit such that shareholders' funds are not merely providing a contingent capital buffer but are in fact absorbing losses of the participants' funds on a regular basis. This situation raises an issue of Shari'ah compliance, since the TO is de facto acting as an insurer. In this connection, thought needs to be given to how to manage the TU so as to avoid such a situation.

The valuation of liabilities affects, among other things: (i) the emergence of surplus within the PRF; (ii) the need for a *qard* to cover valuation strains; and (iii) the basis adopted for pricing *takāful* products and the methods adopted. The valuation of family *takāful* contingent liabilities is left to the discretion of the TO's actuary. This approach, however, can result in issues of equitability when different products are priced differently but are maintained in a single pool. It may also affect the distribution of surplus to the participants. Liabilities can be due to the use of best estimate assumptions plus padding in pricing, but valuing liabilities on a best estimate basis – that is, with no “padding”. Under IFRS-17 accounting rules, the liabilities are

valued with a margin for adverse deviation. The regulatory challenge is how the valuation methodology required for *takāful* products can best ensure equitability of treatment among *takāful* participants, and at the same time provide for capital build-up within the risk pool.

**Q 14. What distinguishes the solvency requirements of TUs from those of conventional insurance?**

Answer: Given a distinction between the PRF and the shareholders' funds of the TO, the solvency requirements for TUs should be set separately. The first level of solvency requirements is to ensure adequate solvency resources in the PRF to provide assurance (on a defined probabilistic basis, and taking account of the possibility of adverse developments in all the areas of risk to which the fund is exposed) that the PRF can meet claims from *takāful* participants. The second level of solvency requirements is to ensure the TO has adequate capital resources to meet its own financial and legal obligations, including the possible need to provide capital backing in the form of a *qard* facility to the PRF.

**Q 15. What does the term “earmarking” mean, as described in the standard?**

Answer: The term is used to describe the assets backing a *qard* facility in the solvency assessments of a PRF. Therefore, it is the responsibility of the supervisor to ensure the assets purporting to be available are indeed available in the circumstances in which they would be called upon for this purpose.

**Q 16. What determines the structure of solvency requirements for PRFs and the TO's funds?**

Answer: The financial and legal obligations of each fund form the basis for determining the solvency requirements of the TU. Therefore, the obligations of each fund in respect of the whole undertaking need to be identified.

**Q 17. What is the objective of conducting a solvency assessment of the PRF of a TU?**

Answer: The objective of solvency requirements at the PRF level is to provide a high degree of confidence that the PRF can withstand adverse conditions over the expected term of its assets and liabilities. Therefore, the PRF should hold assets equal to its technical provisions (valued in the manner described in paragraph 23) plus additional solvency resources (sometimes referred to as solvency margin reserves). The additional solvency resources are the amount of additional assets a PRF must hold to cover (i) possible underestimation of the technical provisions, and (ii) the risk of measurement error inherent in determining the economic values of assets – namely, that their realisable values may be less than their carrying amounts. The additional solvency resources will be calculated for all risks that could have a negative financial impact on a PRF. They will be calculated to cover risks over the expected term of the assets and liabilities. The framework should identify the main categories of risks such as credit, market, underwriting, liquidity and operational.

**Q 18. What is the objective of conducting a solvency assessment of the shareholders' funds of a TU?**

Answer: The objectives of the solvency assessment are twofold. First, it should determine that a TO has sufficient capital resources to be able to withstand unexpected increases in management expenses or reductions in income which could cause operating losses and lead to financial distress if it were undercapitalised. Second, it should determine that the TO has sufficient capital resources to allow it to provide additional capital (as a *qard* facility available to be drawn down) to the PRF should this be necessary to cover a shortfall in that fund's capital resources or a short-term liquidity need, if and to the extent that the TO has proposed, and the supervisor has agreed, that assets of shareholders' fund are available for that purpose.

Thus, the assessment of the amount of the capital resource requirements for the TO's shareholders' fund should be generally based on the potential volatility of expenses and, most importantly, on the level, volatility and flexibility of the TO's income, after taking account of the amount needed for any *qard* facility (i.e. the potential call on the TO to provide additional capital in the form of *qard* if required).

**Q 19. What practices should be avoided in assessing the solvency of the TO's shareholders' fund?**

Answer: The supervisors should avoid two major practices in the solvency assessment of a TO's shareholders' fund. First, the right to receive repayment in respect of a *qard* already provided should not be counted as an asset for the purpose of assessing the TO's solvency, as set out in paragraph 30.B. Second, any assets representing a standby *qard* facility that has been accepted by the regulator as regulatory capital for the purposes of a PRF cannot also be counted as assets supporting the solvency of the shareholders' fund (see paragraphs 34 and 35).

**Q 20. Key Feature 2 states that "the solvency requirements should be established at a level such that the respective amounts of solvency resources in the PRF and shareholders' funds are adequate to meet their respective financial obligations as they fall due, bearing in mind that part of the shareholders' funds may be 'earmarked' to cover a qard facility." What does this sentence imply?**

Answer: This principle emphasises the adequacy of funds' capital resources to meet their respective financial obligations as they fall due. It also highlights the capital components of each fund for solvency purposes. For example, capital available for solvency purposes for the PRF would therefore consist of (i) reserves in PRFs (retained underwriting surplus or investment profit) – that is, *takaful* participants' equity, plus any amount of drawn-down *qard*; and (ii) any undrawn *qard* facility (an earmarked amount within the shareholders' equity). Any amount drawn down from the shareholders' fund as a *qard* facility and any investment income generated from it will form part of the assets of the recipient PRF. Correspondingly, this drawn-down amount will be part of the shareholders' equity and is represented by a *qard* repayable by the PRF.

**Q 21. Key Feature 3 states that "the solvency requirements should establish solvency control levels at the respective PRF and shareholders' funds, that trigger proper interventions by the TO and the supervisory authority when the available solvency is less than the solvency control level." How does a supervisory authority establish a solvency control level?**

Answer: Solvency controls should be set at two levels – in both the shareholders’ fund and the PRF. These control levels are set up such that a set of prompt and proportionate actions could be taken by the TO and the supervisory authority when it is still possible to avert an insolvency position and consequent loss to participants.

**Q 22. How does a supervisor set up solvency control levels?**

Answer: A supervisory authority establishes solvency control levels for the purpose of solvency requirements in the PRF and TO’s shareholders’ funds based on the following four concepts: minimum capital requirement (MCR) and prescribed capital requirement (PCR) for the PRFs; and minimum target capital (MTC) and prescribed target capital (PTC) for the shareholders’ funds.

PCR/PTC signifies the highest solvency level that enables the funds to absorb significant unexpected losses, while MCR/MTC signifies a solvency level a breach of which will invoke the strongest regulatory actions. Any breach of MCR/PCR/MTC/PTC at the level of either the PRF or shareholders’ funds should trigger immediate attention from the TO and the supervisory authority. In any case where a TO is unable to restore the required solvency control level applicable to any PRF, or its own shareholders’ funds, or the whole undertaking, the TO should put forward a plan acceptable to the supervisory authority to meet the solvency requirement within a short period. Where no acceptable plan is put forward and implemented within a reasonable time as specified by the supervisory authorities or as laid down in law, the undertaking should be prohibited from continuing to write further business.

**Q 23. What are the possible intervention actions that could be taken by a supervisory authority?**

Answer: The following measures are available to the supervisor to address solvency levels:

- i. draw-down of the *qard* facility from the shareholders’ fund to the PRF;
- ii. requesting capital and business plans for restoration of solvency resources to required levels;
- iii. limitations on redemption or repurchase of equity or other instruments and/or dividend payments;
- iv. measures intended to protect *takaful* participants pending the restoration of the solvency levels, such as restrictions on undertaking new business, investments, *retakaful*/reinsurance arrangements, etc.;
- v. measures that are intended to enable the supervisory authority to better assess and/or control the situation, either formally or informally, such as increased supervision activity or reporting, or requiring external auditors or actuaries to undertake an independent review or extend the scope of their examinations; and
- vi. measures that strengthen or replace the TO’s management and/or risk management framework and overall governance processes in the TU.

**Q 24. As highlighted in Key Feature 4, how should solvency requirements establish criteria for assessing the quality and suitability of solvency resources in the *takaful* and shareholders’ funds to absorb losses in different financial stages of the respective funds?**

Answer: In assessing the ability of solvency resources to absorb losses in a PRF or the shareholders’ fund, the following characteristics are usually considered (see paragraphs 18 and 51–53):

- i. Availability – the extent to which the capital element is fully paid and can be called up on demand to absorb losses, as well as upon winding-up;
- ii. Permanency – the extent to which the available capital element cannot be withdrawn; and
- iii. Absence of encumbrances and mandatory servicing costs – the extent to which the capital element is free from mandatory payments or encumbrances.

**Q 25. What are the methods applied by the supervisory authority in limiting/ restricting the solvency resources to be qualified to cover different levels of the solvency requirements of the shareholders' fund and PRF?**

Answer: In determining the amount of solvency resources qualified to cover different levels of the solvency requirements of the shareholders' fund and PRF, the supervisory authority may choose an approach that:

- i. categorises solvency resources into different quality classes ("tiers") and applies certain limits/restrictions with respect to these tiers (within which individual tiers may be further subdivided) (tiering approaches);
- ii. ranks capital elements on the basis of the identified quality characteristics (continuum approaches);
- iii. does not attempt to categorise or rank capital elements, but applies individual restrictions or charges where necessary.

The solvency requirements for TUs should take into account the quality of solvency resources to absorb losses in different financial stages of a TU – namely, as a going concern, in run-off, winding-up and insolvency.