

FAQs on IFSB-14:

Standard on Risk Management for Takāful (Islamic Insurance) Undertakings

Q1. What are the main objectives of the IFSB-14 Standard?

Answer: The principles and recommendations set forth in this Standard are intended to achieve the following main objectives:

- to help understand the risks to which a Takāful Undertakings (TU) is exposed;
- to provide minimum standards for the development of a risk management framework for ease of management of the TU and supervision by its governing bodies and supervisory authorities; and
- to help create a safe and prudent environment for the growth, sustainability and development of the Takāful industry.

Q2. What is the scope of application of this Standard?

Answer: This Standard is applicable to all TUs operating under Family Takāful, General Takāful or Composite Takāful licences. The Standard is also intended to be suitable for application to ReTakāful undertakings, to Takāful “windows” of other financial institutions, and to other types of institutions providing insurance functions or models according to Islamic principles.

Q3. What are the Sharī'ah specificities of Takāful Undertakings Relevant to Risk Management?

Answer: There are 4 considerations to be looked at for the Shari'ah specificities, which are as follows:

- **Risk management approach:** a TU aims to uphold the principles of Sharī'ah in providing for pooling of risk of the participants. The application of Sharī'ah principles is therefore fundamental to the operation of the undertaking, and the undertaking should have a Sharī'ah board to assist it in ensuring that these principles are upheld.
- **Risk mitigation:** TUs that are constructed as hybrid entities with an operator also differ from conventional mutuals in various respects; this may affect the incidence of the risks to the undertaking, because of the application of Sharī'ah principles. The differences in the status of the different stakeholders in conventional insurance and Takāful affect the incidence of risks among the different types of stakeholder and have consequences for the way those risks need to be managed. Means of mitigating risks to participants' interests may not necessarily be effective in mitigating the impact of the same risks on the interests of shareholders, or vice versa, and the interests may conflict.

- **Relationship between the stakeholders:** the risk management framework established by the Takāful Operator (TO) for the TU needs to take into account the relationships between the stakeholders based on the application of Sharī'ah principles. The segregation of funds in a TU between one or more PRFs, as well as the Shareholders' Fund (SHF) and any PIF, reflects the separate status of each fund's beneficiaries⁶ in the operational activities of the TU. This Standard addresses questions of risk management at the level of the separate funds, considering the risks to which each type of stakeholder is exposed and including risks between different types of stakeholders.
- **Fiduciary responsibility:** while the participants in a PRF of a TU bear collectively the underwriting risks of that PRF, and those in a PIF bear the investment risks of that PIF, the TO has the fiduciary responsibility of managing different segments of the undertaking in the interests of these stakeholders. Although the TO is not contractually liable under Sharī'ah for losses or deficits suffered by a PIF or PRF, except any losses or deficits due to the TO's own negligence and misconduct, this fiduciary responsibility requires the TO to exercise diligence and commitment to serving the interests of the participants in those funds. For example, the TO manages the risk profile of the PRF on behalf of the participants, with the aim of keeping the fund solvent at all times. The TO has also to consider the exposure of shareholders (through their ownership interest in the SHF) to any resultant risks, insofar as the operating model involves the use of a Qarḍ or similar facility as a means of providing capital back-up or liquidity support to the PRF.

Q4. What are the risks specific to Takāful Undertakings?

Answer: There are three main risks specific to TU:

- **Risk of Sharī'ah non-compliance:** breach of Sharī'ah principles may render contracts invalid under Sharī'ah, deprive a participant of Takāful protection, cause loss to the entity, damage its reputation, and expose it to regulatory action, and may have repercussions in terms of the incidence and management of other risks. [Para. 19]
- **Risks arising from segregation of funds:** another specificity of a TU which requires specific attention is the separation of funds attributable to participants from each other and from those attributable to shareholders. [Para. 23]
- **Risks relating to the use of ReTakāful:** the development of the Takāful industry has been accompanied by differing views as to the validity under Shari'ah of the use of conventional reinsurance by Takāful and ReTakāful¹³ undertakings. In addition, differences have emerged in the manner in which individual ReTakāful contracts are effected and the attribution as between funds, in both the ceding and reinsuring undertaking, of revenues and expenses ancillary to the actual risk-sharing transaction (e.g. commissions). TOs need to ensure that the attribution of such revenues and

expenses is transparent to participants, and also (in view of the complexity of this aspect of business) that the fairness of the attribution is considered objectively. [Para 29]

Q5. How the operational risk is defined in this Standard and recommended approach for the Takaful Operator?

Answer: Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. For TUs, this also includes risk of loss resulting from Sharī'ah non-compliance and failure in a Takāful Operators (TO)'s fiduciary responsibilities.

TOs should aim to identify all potential causes for operational failure of the TU, including failure in internal processes, possible negligent, incompetent or fraudulent activities of its internal human resources, and other failures of its systems.

Q6. How the Shari'ah non-compliance risk is confluence with the operational risk?

Answer: Sharī'ah non-compliance risk is an operational risk which requires processes and controls to prevent non-compliance and to detect and correct any instances that do occur. This risk is pervasive in the operations of a TU. For example, the products of TUs should be Sharī'ah compliant, and the overall product cycle of a TU therefore requires consideration of Sharī'ah compliance, including the possibility that a contract accepted incorporates, or changes during its currency to incorporate, elements that are individually non-compliant.

Q7. How the underwriting risk is defined in this Standard and recommended approach for the TO?

Answer: Underwriting risk is the risk of loss due to underwriting activities relating to the Participants' Risk Fund. Sources of this risk include assumptions used in pricing or assessment that are subsequently shown to be incorrect by experience of, for example, claims.

The TO should establish and document, with the assistance of the TU's actuary, an appropriate mechanism to determine the type of assumptions to be used. The result of this exercise should be considered, prior to approval of any products, to help ensure that any new type of risk is only accepted into the PRF after consideration of the adequacy of its pricing, and that products in issue are regularly assessed from a similar perspective.

Q8. How the market risk is defined in this Standard and recommended approach for the TO?

Answer: Market risk is the risk of losses arising from movements in market prices – that is, fluctuations in values in tradable, marketable or leasable assets (including Sukūk) and a deviation of the actual rate of return from the expected rate of return.

A TO should establish policies governing the investment strategy that it intends to adopt, based on its ability to absorb fluctuations. Prior to making any investment decisions, the TO is expected to assess the market risks of each investment instrument in which the TO plans to invest. The risk exposures need to be taken into consideration in its risk quantification process to ensure that the impact of any fluctuations in the investment activities or of any economic changes in the market on the several funds of the undertaking is identified and quantified, along with any correlations with other assets and liabilities of the TU.

Q9. How the credit risk is defined in this Standard and recommended approach for the TO?

Answer: Credit risk is the risk that a counterparty fails to meet its obligations in accordance with agreed terms. Credit risk in a TU may arise from operational, financing and investment activities of the funds. A similar risk may arise from ReTakāful activities of the funds.

It is the responsibility of the TO to ensure that, prior to agreeing to invest in any kind of investment instruments or any other kind of activities involving a credit risk, proper measures are put in place to ensure that the risks to the several funds are identified and quantified, monitored and, where appropriate, mitigated.

Q10. How the liquidity risk is defined in this Standard and recommended approach for the TO?

Answer: Liquidity risk is the risk of loss to a Takāful undertaking arising from its inability either to meet its obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.

Appropriate liquidity management policies should be put in place and subjected to regular assessment as to their continuing appropriateness and adequacy to meet foreseeable liquidity requirements. For example, where liquidity management policies include dependence on ability to raise money through banks or capital markets, the TO should include contingency plans for scenarios where market conditions are such that these sources are unavailable in practical terms.

Q11. How the legal and compliance risk is defined in this Standard and recommended approach for the TO?

Answer: Legal and compliance risk is risk relating to the legal and regulatory implications arising from the TU's operational activities and dealings with its stakeholders, including both the possibility of adverse outcome of legal disputes or contractual difficulties and the consequences of failure to comply with requirements to which the TU is subject.

TOs should ensure that conflicting interests are reconciled in such a manner as to avoid any appearance of impropriety, because of the risk of reputational damage, supervisory intervention or litigation. These issues are addressed in more detail in IFSB-8: Guiding Principles on Governance for Takāful (Islamic Insurance) Undertakings.

TOs should also be alert to the risk of use of the TU for financial crime. The TO should establish procedures for the prevention, detection and reporting of suspected money-laundering, fraud or other financial crime, including breach of international sanctions. While local laws will generally set minimum requirements in this regard, a TO should consider whether those minimum requirements are adequate to control the financial and reputational risk to the TU from any incident of financial crime involving the TU.

Q12. What are the key essential features of the Enterprise Risk Management regulated in this Standard?

Answer: A TO, in its capacity as manager of the participants' funds, should accordingly establish and review regularly a framework for managing the different risks of the undertaking. This framework, which is commonly described as an "enterprise risk management framework", should be comprehensive in nature, dealing with all risks of the funds making up the TU, and should formalise through a set of policies, consistently applied, the TO's approach to determining the appetite for risk, its process for managing risks and its governance related to risk.

The key essential features of Enterprise Risk Management for the TU include the following:

- **Risk policies and strategies:** a TO should clearly document its risk policies and strategies within a risk management framework that is appropriate to the nature and scale of its activities, including the specificities of the TU's operating model and its Sharī'ah obligations. Policies and strategies should be developed in a manner consistent with the risk management framework, to provide clear guidance to the personnel within the organisation as to the approach to be adopted towards business risks. These policies should be reviewed on a regular basis by the TO. [Para 46]
- **Risk identification:** risk identification is the process whereby the TO considers and records all foreseeable events whose occurrence could have an impact on the financial condition or otherwise sustainability of a TU. Once a risk has been identified, it is entered onto the risk register. [Para 51]
- **Risk assessment, response and control:** following the risk identification process, each identified risk will be assessed. The TO should have a process for estimating, for each risk, the probability that it will occur, the likely consequences if it does so, when it could occur, and the possible means of avoiding, mitigating or transferring it. This process may

commence at the same time as risk identification, as those who identify a risk frequently contribute to its assessment. [Para 56]

- **Control framework:** a TO should establish and maintain a control framework that reflects the risk policies adopted. The purpose of an internal control framework is to provide assurance at all levels of management that business processes are being adhered to, and ultimately to enable the board to determine that the undertaking is following the approved strategy and risk appetite, agreed policies and processes, and applicable laws and regulations. [Para 60]
- **Risk monitoring:** a TO should monitor the status of the risks that it has identified, through adequate management information systems. Relevant and measurable performance indicators should be identified for each risk, and should be monitored regularly. Performance indicators may be qualitative or quantitative. The information prepared for risk monitoring purposes should include information on all significant breaches of policy. Those responsible for monitoring the status of risks should receive risk information independently of operational management. [Para 63]
- **Risk reporting:** a TO should maintain a comprehensive reporting process for all the risks of the organisation. The reporting process should cover all internal and external risk reporting requirements, including how relevant and reliable risk information is captured at the appropriate level of detail for each level of user, including operational management, the risk management committee or equivalent body, the BOD, the Sharī'ah board, and any required public or regulatory reporting. In designing the risk reporting process, the TO should consider the information needs of each recipient. [Para 68]

Q13. What is the role of Sharī'ah Board within risk governance of the TU?

Answer: Where a Sharī'ah board is required or requested to express an opinion (whether publicly or internally, and whether on a periodic basis or ad hoc) on the Sharī'ah compliance issues of a particular or general activities of the TU, it should consider, so far as concerns the matter on which it is required or requested to opine, the following:

- The nature and extent of risks of non-compliance; and
- The policies and procedures that the TU has in place to manage those risks.

The Sharī'ah board should evaluate the results of the TO's supervision of the application of those policies and procedures, whether or not the governance system of the undertaking assigns it the responsibility for carrying out that supervision.

Q14. What is Own Risk and Solvency Assessment (ORSA)?

Answer: The ORSA is a key aspect of the risk management system of a TU. It is a mechanism by which a TO continually assesses, based on its planned level of business and risk management framework, its financial strength on a forward-looking basis. The result of the ORSA is periodically reported to the BOD to assist in strategic decision-making and to assess the resilience of the TU to foreseeable events. The ORSA involves challenging the TU's current financial system and risk management framework via quantitative measurements of identified risk exposures in stressed conditions. The output of the ORSA assists the TO in the early identification of weaknesses that may be threats to business continuity, providing more time to develop and implement solutions.

Q15. What are the key elements in the Supervisory Review Process of Risk Management for Takāful Undertakings?

Answer: A supervisory authority may pay particular attention to the following matters, among others:

- **Existence and operation of a framework.** Every TO should have in place a risk management framework, established under the authority of the BOD, that provides clear upward and downward communication of risk issues and policies. The framework should be clearly documented and reflective of the processes that are actually carried out in the business. The TO should be able to demonstrate that the framework is used in the day-to-day management of the business, and is not merely in existence to satisfy a regulatory requirement.
- **Qualitative aspects of risk governance.** The supervisory authority should consider whether the risk management governance functions identified at paragraph 68 of this Standard are carried out by persons who are appropriately skilled for their function, possess adequate authority and adequate resources for the conduct of their function without restriction, and are sufficiently free of conflicting duties to preserve objectivity in carrying out their functions.
- **Effectiveness of risk management processes.** The existence of a framework does not guarantee its effectiveness. The supervisory authority should consider the design of the framework, and such evidence as is available to demonstrate that the risk management processes are effective in operation. Methods available to the supervisor to assist in its assessment include on-site inspection, review of supervisory reporting, and, if the supervisor considers it necessary, provision of an independent report on the effectiveness of the risk management framework.

- **Fund separation issues.** The supervisory authority should consider whether the risk management framework adequately reflects the separation of funds between the PRF, PIF and the SHF. In performing its review, the supervisor should consider how the risks in each separate fund are identified, assessed and addressed based on each fund's distinct nature and function.
- **Relevance of tests to the TO.** In considering the results of a TO's stress tests, the supervisor should consider whether the parameters used are relevant to the nature of the TO's business, and whether there are relevant stresses that have not been tested.
- **Clarity of Sharī'ah-compliance responsibilities.** As Sharī'ah non-compliance is a specific risk of Takāful, even in jurisdictions where the supervisory authority has no responsibility for Sharī'ah supervision, the supervisor should consider whether the risk management framework appears to address the risk of Sharī'ah non-compliance. A supervisor might, for example, look for evidence of involvement of the Sharī'ah board in the assessment of these risks, and of a process for testing controls over Sharī'ah compliance.
- **Issues on ReTakāful.** Some different views exist as to the proper use of ReTakāful by TUs. In performing its review, the supervisory authority should consider whether the policy of the TO with respect to the use and treatment of ReTakāful reflects the advice of the TU's Sharī'ah board. The supervisor may also consider whether any risks arising from the nature of the TO's policy on use and treatment of ReTakāful have been adequately addressed in the risk management framework.
- **Supervisory reporting.** The supervisory authority should consider the implementation of formal requirements for TOs to report to the supervisory authority in respect of risk management. Such reporting requirements should include a periodic ORSA report, as well as reports to the supervisory authority on the happening of specified risk events. The frequency and scope of such reporting requirements may be responsive to the nature, scale and complexity of an individual TU's business. The supervisor should consider whether reports should require independent external assessment.

Q16. What are the systemic risk considerations in Takāful ?

Answer: "Systemic risk" in this document refers to the transmission of shocks within the entire Takāful sector or the insurance industry in general, or at the macro level between the Takāful sector and the Islamic banking or capital market sectors, or other financial institutions, or any other kind of circumstances whose occurrence has an impact on the entire financial system. The supervisor should be alert to the risk of concentration of exposures to an entity or to a sector that is not apparent at the level of a single entity.