EXPOSURE DRAFT

CORE PRINCIPLES FOR ISLAMIC FINANCE REGULATION [TAKĀFUL SEGMENT]

31 March 2022

Comments on this Exposure Draft should be sent to the IFSB Secretariat no later than 23 June 2022 at email public_consultation@ifsb.org
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<tr>
<td>ALM</td>
<td>Asset liability management</td>
</tr>
<tr>
<td>BCBS</td>
<td>Basel Committee on Banking Supervision</td>
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<tr>
<td>ComFrame</td>
<td>Common Framework for the Supervision of Internationally Active Insurance Groups</td>
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<td>CPIFR</td>
<td>Core principles for Islamic finance regulation</td>
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<td>ERM</td>
<td>Enterprise risk management</td>
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<td>IADI</td>
<td>International Association of Deposit Insurers</td>
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<tr>
<td>IAIG</td>
<td>Internationally active insurance groups</td>
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<td>IAIS</td>
<td>International Association of Insurance Supervisors</td>
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<td>ICP</td>
<td>Insurance core principle</td>
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<td>IFSB</td>
<td>Islamic Financial Services Board</td>
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<td>IFSB-8</td>
<td>Guiding Principles on Governance for Takāful (Islamic Insurance) Undertakings</td>
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<td>Guiding Principles on Sharī'ah Governance Systems for Institutions offering Islamic Financial Services</td>
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<td>Core Principles for Islamic Finance Regulation (Banking Segment)</td>
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<td>Key Elements in the Supervisory Review Process of Takāful/Retakāful Undertakings</td>
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<td>Core Principles for Islamic Finance Regulation (Islamic Capital Market Segment)</td>
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<td>IFSB-25</td>
<td>Disclosures to Promote Transparency and Market Discipline for Takāful/Retakāful Undertakings</td>
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<tr>
<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
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<td>JWG</td>
<td>Joint working group</td>
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<tr>
<td>MCR</td>
<td>Minimum capital requirement</td>
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<tr>
<td>MOCE</td>
<td>Margin over the current estimate</td>
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<td>ORSA</td>
<td>Own risk and solvency assessment</td>
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<tr>
<td>Acronym</td>
<td>Description</td>
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<tr>
<td>PIF</td>
<td>Participants’ investment fund</td>
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<td>PRF</td>
<td>Participants’ risk fund</td>
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<td>RSA</td>
<td>Regulatory and supervisory authority</td>
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<td>RTO</td>
<td>Retakāful operator</td>
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<td>RTU</td>
<td>Retakāful undertaking</td>
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<tr>
<td>SHF</td>
<td>Shareholders’ fund</td>
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<td>TCP</td>
<td>Takāful core principle</td>
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<td>TO</td>
<td>Takāful operator</td>
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<td>TU</td>
<td>Takāful undertaking</td>
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SECTION 1: INTRODUCTION

1.1 Background

1. Core principles for supervision have become standard tools to guide regulatory and supervisory authorities (RSAs) in the financial services sector in developing their regulatory and supervisory regimes and practices. They also serve as the basis for assessment by RSAs themselves, or by external parties such as multilateral agencies, of the strength and effectiveness of the design of a jurisdiction’s financial services regulation and supervision. Core principles have been adopted for each of the banking, capital markets and insurance sectors by, respectively, the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). The International Association of Deposit Insurers (IADI) has similarly developed core principles for effective deposit insurance systems.

2. Perceiving a need for core principles in the area of Islamic finance, the Secretariat of the Islamic Financial Services Board (IFSB) undertook a review of the applicability of the BCBS, IOSCO and IAIS core principles across the three sectors of Islamic finance (banking, capital markets and takāful, respectively). The substance of the analysis was published in November 2014 as WP-02: Working Paper on Evaluation of Core Principles Relevant to Islamic Finance Regulation. This analysis was performed at the level of the standards within each of the core principles, indicating how far they may be applied to the supervision of Islamic financial services, as well as the type of changes or additions that may be required to those core principles for this purpose, taking into consideration the specificities of Islamic financial services.

3. Specificities of Islamic financial services include the obligation to comply with Shari’ah rules and principles. Thus the BCBS, IOSCO and IAIS core principles would be unsuitable for application if, and to the extent that, they conflicted with Shari’ah rules and principles.

4. Building on the work documented in WP-02, the IFSB has since developed and adopted sets of IFSB core principles for Islamic finance regulation (CPIFR) with the issuance of IFSB 17: Core Principles for the Islamic Finance Regulation (Banking Segment), in April 2015; IFSB-21: Core Principles for Islamic Finance Regulation (Islamic Capital Market Segment), in December 2018; and IADI-IFSB: Core Principles for Effective Islamic Insurance Deposit Systems, in July 2021.
5. The IAIS insurance core principles (ICPs) have provided a reference point for the IFSB in developing supervisory standards for takāful from an early stage of development of both the IAIS and the IFSB standards. The IFSB and the IAIS issued a joint paper (Issues in Regulation and Supervision of Takāful [Islamic Insurance]) in August 2006 discussing the applicability of the IAIS ICPs (as adopted in October 2003) to the regulatory and supervisory standards for takāful to be developed by the IFSB and seeking to identify the specific and immediate issues for prioritisation in the IFSB work plan for takāful. The analysis in WP-02 (referred to above) was performed by reference to the IAIS ICPs as substantially revised in 2011.

6. These two analyses indicated that the ICPs developed principally for conventional insurance may, in many but not all respects, be accepted as universally recognised principles, capable of application to takāful with little or no adaptation. However, in other areas the ICPs require further expansion or amendment for effective application to the takāful area. In particular, they do not adequately or clearly address some Sharī‘ah considerations (including Sharī‘ah governance, qarḍ and takāful business models), and the separation of funds between the shareholder and policyholder funds commonly adopted in takāful.

7. Accordingly, in continuation of its programme for the development of core principles for regulation and supervision in Islamic finance, the IFSB established a working group tasked with the drafting of the Core Principles for Islamic Finance Regulation (Takāful Segment). These core principles for takāful were developed to address the issues identified on preliminary analysis in the joint paper in WP-02 but should not otherwise differ greatly from the ICPs as most recently revised in November 2019.

1.2 Objectives

8. This standard is intended to set out a set of takāful core principles (TCPs), closely aligned with the ICPs (as adopted in November 2019) but modifying and adding to them as necessary to reflect the application of Sharī‘ah principles in takāful. The aim is to provide an international benchmark standard to promote a sound regulatory and supervisory system for maintaining a fair, safe and stable takāful sector for the benefit and protection of the interest of takāful participants, beneficiaries and claimants, as well as contributing to the stability of the Islamic financial system. A hierarchical structure of principles, standards and guidance material, consistent with that of the ICPs, is proposed for the TCPs, in order to provide clarity and facilitate reading of the TCPs together with the ICPs and other relevant standards.

1 The nature of takāful is described in Section 1.3 of this standard. As indicated in paragraph 29, reference to takāful includes retakāful.

2 See paragraph 30 for the meaning of this term as used in this standard.
9. The objectives of this standard include the following:

a. to provide an appropriate international standard for sound regulatory and supervisory practices specifically for the takāful sector;

b. to enable policymakers and supervisors to self-assess the level of observance of principles and standards in the regulations;

c. to identify areas for improvement and guide development of reform agendas and responses to emerging issues; and

d. to provide a basis for peer review enabling objective external assessment by specialised bodies.

10. Where applicable, Sharīʿah governing bodies may also wish to refer to the TCPs to inform their understanding of supervisory expectations as to Sharīʿah governance matters in the takāful sector in their jurisdictions.

1.3 Specificities of Takāful

11. *Takāful* is a form of financial protection whose contracts and operations are expected to be in compliance with Sharīʿah rules and principles. The expectation of Sharīʿah compliance necessitates, among other things, governance arrangements designed to ensure and maintain Sharīʿah compliance. It also leads to certain features specific to takāful that may provide valuable context to the TCPs. Specificities of takāful business include, or may include, the following:

a. *Tabarru'* commitment, which is a type of Islamic financial transaction used in takāful schemes. It is the amount contributed by each takāful participant to fulfil obligations of mutual help and to pay claims submitted by eligible claimants.

b. The concept of *ta'awun*, or mutual assistance to the operation of takāful, with participants agreeing to compensate each other mutually for the losses arising from specified risks.³ As the indemnification commitment under takāful is cooperative, or mutual, its primary objective is not to gain a profit but to provide mutual assistance. In this way, speculative risk (*maisir*), which is prohibited under Islam, is avoided, and any uncertainty inherent in the contractual arrangement (*ghārar*) is mitigated.

³ In practice, a takāful operator initiates the mutual agreement, enabling potential takāful participants to identify in the marketplace, and to subscribe to, takāful arrangements of the desired types, rather than having first to seek other like-minded persons with whom to form an agreement.
c. The potential that a *takāful* operator (TO), as manager of the *takāful* undertaking (TU), is required to maintain segregated funds, typically as follows:

- one holding the shareholders' equity of the TO (sometimes referred to as the shareholders' fund, or SHF), to which administrative and other operational transactions are attributed; and
- one or more risk-bearing *takāful* funds,\(^4\) managed by the TO, to receive the contributions of the *takāful* participants and investment income on those funds, and out of which losses or other entitlements are paid; with
- remuneration for managing the *takāful* business paid to the SHF according to the terms of the *takāful* contracts.

d. *Takāful* funds are, in this case, attributable to the *takāful* participants collectively, and surpluses and deficits arising on *takāful* activity are similarly attributable to them.

- The disposition of surpluses is dealt with either in legislation, in the constitutional documents of the TU, in the TU’s prudential policies, or in the *takāful* contracts themselves. Surpluses may be retained within the fund to provide working capital, applied directly or indirectly to the benefit of the *takāful* participants, or applied to charitable purposes.
- Deficits arising on *takāful* activity may be covered by surpluses previously retained within the *takāful* fund. In the event that a *takāful* fund has insufficient funds to meet its *takāful* obligations, legislation, the constitutional documents or the contracts may provide for different mechanisms for meeting the deficiency.\(^5\) In order to provide a temporary financing facility, the TO may provide, out of the SHF, or procure from a third party, a *qarḍ*,\(^6\) to be repaid out of future surpluses.

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\(^4\) These are sometimes referred to as participants’ risk funds (PRFs), where insurance risk is borne on a *takāful* basis (typically, though not exclusively, in general *takāful*) and participants’ investment funds (PIFs), which bear investment risk (typically, in family *takāful*). Depending on the adopted structure or national requirements, funds may be segregated further – for example, with separate savings and investment funds in place of a single PIF. As an example, a business model may involve a separate PIF to hold an element of contribution not paid into the PRF to cover the risk but placed separately for investment, but available for transfer should the PRF require it.

\(^5\) On the principle that the funds are attributable to *takāful* participants, a deficiency might be met by calling additional contributions from *takāful* participants or reducing compensation due to them. However, such mechanisms may be impracticable, or represent risks to the interests of beneficiaries that are unacceptable to policymakers.

\(^6\) Unless otherwise stated, *qarḍ* in this standard represents *qarḍ hasan* – that is, a loan without remuneration. The amount to be repaid on such *qarḍ* is the principal amount advanced.
• To the extent that a deficit is due to the negligence or misconduct of the TO, the operator is responsible for compensating the *takāful* fund.

e. A commitment to Shari'ah compliance in all activities.

12. These specificities produce additional dimensions to the risk profile of *takāful* operations, not necessarily foreseen in the IAIS ICPs. One consequence of segregation of funds, where practised, is the enhancement of fiduciary responsibility and risk. The intention of Shari'ah compliance, throughout the organisation and its products and activities, in addition to its objective of ensuring obedience to Allah, has prudential and conduct risk implications from both regulatory and macroprudential perspectives. The economic consequences of Shari'ah non-compliance may include financial losses, liquidity issues, disputes, reputational damage and loss of public trust in the Shari'ah integrity of individual *takāful* operations or of the *takāful* sector (or even the Islamic financial sector as a whole). Ultimately, Shari'ah non-compliance may impact financial stability.

1.4 General Approach of the CPIFR-*Takāful*

13. In line with the IFSB’s Articles of Agreement, the CPIFR-*Takāful* standard is built on the basis of complementing IAIS standards – namely, in this case, the 24\(^7\) ICPs (as at November 2019), together with the accompanying introduction and assessment methodology.

14. The CPIFR-*Takāful* retains the text of the IAIS ICPs with appropriate terminological adjustments, whenever possible, in view of its common applicability to conventional insurance and *takāful*. Additions, modifications and deletions are made in this text to address *takāful* specificities.

15. Two further principles are added to the existing 24 IAIS ICPs in order to reflect *takāful* specificities for which the existing ICPs do not provide a framework for adaptation. These additional principles relate to Shari'ah governance and window operation. Thus, the TCPs comprise 26 principles numbered in sequence as closely as possible to that of the IAIS ICPs. A correspondence table is provided in a separate document on the IFSB website to assist users of the standard to identify the correspondence between the TCPs and ICPs.

*Structure*

16. The TCP material is presented according to the following hierarchy:

\(^7\) The ICPs are numbered from 1 to 25, but there is no longer a separate ICP 11.
a. **Principle Statements:** This is the highest level in the hierarchy. The principle statements set out the essential elements that must be present in a jurisdiction in order to protect policyholders, promote the maintenance of fair, safe and stable insurance markets, and contribute to financial stability. In each TCP, the principle statement is numbered and presented in a box with bold font.

b. **Standards:** The next level in the hierarchy is linked to specific principle statements. Standards set out key high-level requirements that are fundamental to the implementation of the principle statement and should be met for a jurisdiction to demonstrate observance with the particular principle statement. Standards are presented in bold font, with the number of the applicable principle statement followed by the standard number.

c. **Guidance:** This lowest level in the hierarchy supports the principle statement and/or the standards. Guidance facilitates understanding and application of the principle statement and/or standards; it does not represent any requirements. The wording used in guidance varies to reflect the intended weight of the text; for example, the use of “should” provides more of a recommendation, whereas the use of “may” is more of a suggestion. Where appropriate, guidance provides examples of ways to implement the principle statements and/or standards. Guidance is presented in regular font, with the number of the principle statement and standard followed by the guidance number.

**Future Development of IAIS Materials**

17. The text of the ICP materials referred to when developing the TCPs is that as updated at the IAIS Annual Conference held in Abu Dhabi in November 2019, with terminological modifications to reflect application to *takāful*. Amendments subsequently made to the text of those ICP materials are not incorporated, unless agreed by the Council of the IFSB.

18. Future developments in the ICP materials may create inconsistency with the core principles of *takāful* supervision. Therefore, any such developments will require IFSB assessment to determine whether amendment or addition is necessary for the purposes of incorporating them in the CPIFR-*Takāful* material. Pending the conclusion of such assessment, it falls to supervisors to determine whether any such developments should be reflected in their supervisory frameworks for *takāful*. In making that determination, supervisors should consider the requirements of this standard and other IFSB pronouncements.

1.5 **Overarching Principles**

19. There are a number of important overarching concepts to understand and keep in mind when reading and implementing the TCPs. While an individual TCP
may focus on one particular subject, the TCPs need to be considered as a whole with these overarching concepts being relevant throughout.

**Applicability**

20. This standard is intended for application to *takāful*, which is distinguished from most conventional insurance by the intention that the contracts and the business are conducted in accordance with the Sharī`ah, which has effects on the contractual basis of the protection provided and the nature of the operator’s business activities (e.g. the assets in which it may invest).

21. The standard is developed primarily by reference to the “hybrid” *takāful* structure adopted by many TUs. The terminology adopted in this standard follows this model.

22. However, provisions of this standard are, where relevant, applicable also to other models of *takāful* or Islamic insurance, however described. Reference in TCPs to *takāful* practices may require modification when RSAs apply TCPs to supervision of models of *takāful* or Islamic insurance other than the model illustrated in this standard.

23. Where the same supervisor has responsibility for supervising both conventional insurance and *takāful*, this standard applies separately in respect of its supervision of *takāful*, without prejudice to the application, where relevant, of other supervisory standards (in particular, the ICPs) to its supervision of conventional insurance.

**Proportionality and Risk-Based Supervision**

24. The TCPs establish the minimum requirements for effective *takāful* supervision and are expected to be implemented and applied in a proportionate manner. Therefore, proportionality underlies all the TCPs. Supervisors have the flexibility to tailor their implementation of supervisory requirements and their application of *takāful* supervision to achieve the outcomes stipulated in the principle statements and standards.

   a. **Implementation:** Proportionality allows the TCPs to be translated into a jurisdiction’s supervisory framework in a manner appropriate to its legal structure, market conditions and consumers.

   b. **Application:** Proportionality allows the supervisor to increase or decrease the intensity of supervision according to the risks inherent to TUs, and the risks posed by TUs to *takāful* participants, the *takāful* sector or the financial system as a whole. A proportionate application involves using a variety of supervisory techniques and practices that are tailored to the TU to achieve

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8 See IFSB-8, paragraph 5: ‘a typical undertaking consists of a two-tier structure that is a hybrid of a mutual and a commercial form of company which is the *takāful* operator (TO).’
the outcomes of the TCPs. Such techniques and practices should not go beyond what is necessary in order to achieve their purpose.

25. Supervisors should therefore consider proportionality in applying this standard by taking into consideration the nature, scale and complexity of TUs and the environment in which they operate. It may not always be necessary to apply all of its requirements to all classes of takāful business; however, the application of proportionality should always have regard to the objectives of takāful supervision.

26. Risk-based supervision is a related concept but distinct from proportionality. It means that more supervisory activities and resources are allocated to supervision of TUs, TOs, lines of business or market practices that pose the greatest risk to takāful participants, the takāful sector, or the financial system as a whole. In the context of takāful, relevant risks may include risk to public confidence in the Sharī`ah integrity of the sector.

Terminology

27. In this standard, terms have the meanings set out in the definitions provided in Appendix 1 (unless stated otherwise or the context indicates otherwise).

28. The term “supervision” is used to refer to supervision and regulation, and “supervisor” to the authority with responsibility for supervision of the takāful industry. Similarly, the term “supervisor” also refers to “regulator”. The expectation is that the principle statements and standards are implemented within a jurisdiction by all authorities in accordance with their respective responsibility in relation to insurance supervision, and not necessarily by only one authority. Therefore, the term “supervisor” is used to refer collectively to those authorities within a jurisdiction with such responsibility. It is essential in situations where multiple authorities exist that arrangements are established between them to ensure that the implementation of the principle statements and standards within the jurisdiction occurs within a framework that makes clear which authority is accountable for which functions.

29. The term “takāful” includes retakāful unless otherwise stated or the context requires otherwise.

30. The term “takāful participant” is used to refer to a person (natural or legal) who participates in a takāful contract with a TU and has the right to compensation
or other entitlements under a **takāful** contract and includes, where relevant, beneficiaries and claimants with a legitimate interest in the **takāful** contract.⁹

31. **The term “takāful operator”** is used to refer to any establishment or entity that manages a **takāful** business – which may be, though is not necessarily, a part of the legal entity in which the **takāful** participants’ interests are held.

32. **The term “takāful undertaking” means Islamic insurance undertakings, taking together the TO and the funds that it manages, notwithstanding that under some models the operator and the funds may not be within the same legal person. The principle statements and standards apply to the supervision of **takāful** operations and, unless otherwise specified, to Islamic insurance groups, including the head of the Islamic insurance group, and to **takāful** operations within conventional insurance groups. The application of TCPs to different forms of operation may vary and, where necessary, further guidance is provided.**

33. **The term “insurance group” includes a group of companies operating **takāful** businesses, and a group conducting both conventional insurance and **takāful** business.**

34. **The term “window” means part of a conventional insurer (which may be a branch or a dedicated unit of that insurer) that provides **takāful** services (other than purely as an intermediary).**

**Group-Wide Supervision**

35. **It is recognised that the implementation of the principle statements and standards relevant to group-wide supervision may vary across jurisdictions depending on the supervisory powers and structure within a jurisdiction. There are direct and indirect approaches to group-wide supervision.**

   a. **Under the direct approach, the supervisor has the necessary powers over the parent and other legal entities in the insurance group and can impose relevant supervisory measures directly on such legal entities, including non-regulated legal entities.**

   b. **Under the indirect approach, supervisory powers focus on the TUs and supervisory measures are applied to those TUs to address the group-wide risks posed by other entities within the group, including non-regulated legal entities.**

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⁹ The term “policyholder” is also commonly used in the market to describe the customer under any form of insurance contract, conventional or **takāful**. The term “participant” may also have other meanings in different contexts related to **takāful**. The term “**takāful** participant” is used to avoid ambiguity.
There may also be different combinations of elements of direct and indirect approaches.

36. Regardless of the approach, the supervisor must be able to deliver effective group-wide supervision, including that all relevant group-wide risks impacting the takāful entities are addressed appropriately.

37. A group-wide supervisor may in any case be required to have regard to principle statements and standards in both the ICPs and the TCPs, as applicable to the legal entities within the group, where a group includes legal entities conducting both conventional and Islamic insurance activities.

38. The principle statements and standards relevant to group-wide supervision are also applicable to some degree where a legal entity conducting conventional insurance or reinsurance operates an Islamic window within that legal entity for the conduct of takāful business. Relations between the window and the host conventional insurer or reinsurer may have similarities to those between a subsidiary and the group of which it is a member.

**Group Corporate Governance, Shari‘ah Governance and Materiality**

39. The head of an insurance group is ultimately responsible for the group’s sound and prudent management. In doing so, it is important to take into account the risks and activities of the individual legal entities within the group, focusing in particular on those that are material for the group as a whole.

40. While the ultimate responsibility for an insurance group’s corporate governance lies with the head of the group, the legal entities within the group are fully responsible for their own sound and prudent management.

41. The head of the group has a responsibility to ensure that appropriate arrangements for Shari‘ah compliance are established and maintained by those legal entities for which that is relevant. However, the responsibility of the head of the group under group supervision provisions does not detract from the accountability of each legal entity within the group to which Shari‘ah governance requirements are applicable, for its own effective Shari‘ah governance.

**The TCPs and ComFrame**

42. The Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame), adopted by the IAIS on 14 November 2019, establishes enhanced supervisory standards and guidance focusing on the effective group-wide supervision of internationally active insurance groups (IAIGs). This should help supervisors address group-wide risks and avoid supervisory gaps. One of the main objectives of ComFrame is to support coordination of supervisory
activities between the group-wide supervisor and other involved supervisors. As such, ComFrame will provide supervisors with a common language for the supervision of IAIGs.

43. By coordinating supervisory activities and exchange of information about IAIGs between group-wide and other involved supervisors, the implementation of ComFrame should result in more efficient supervisory processes, for the benefit of both supervisors and IAIGs.

44. The application of ComFrame depends upon the international activity and size of IAIGs. An increasing number of TUs have subsidiaries in other jurisdictions. However, as at the time this standard was developed, none had attained a level to be identified as an IAIG. Accordingly, the TCPs do not include materials relating to ComFrame, except indirectly relating to the obligations on the supervisor of a TU that is a member of an IAIG.

45. It is recognised that a number of IAIGs include takāful operations, either as separate legal entities (wholly owned or joint ventures) or as windows. As takāful supervisors will be participating in supervision activities of conventional insurance groups subject to ComFrame, takāful supervisors must be able to contribute to those activities and to observe those ComFrame standards that are not addressed solely to the group-wide supervisor. The supervisor of the takāful operations is likely, as a consequence of the requirements of ComFrame, to need to cooperate with group-wide supervisors and other relevant supervisors, who may be unfamiliar with takāful. The development of guidance for conventional insurance group supervisors is beyond the IFSB’s scope. Further discussion with other standard-setting bodies is needed to determine how such guidance might be achieved.

The TCPs and Other IFSB Standards Concerning Takāful, and Standards of Other International Standard-Setting Bodies

46. This standard shall be read together with other relevant IFSB standards and with the requirements of other international standard-setting bodies, including the Financial Action Task Force (FATF), an inter-governmental body established to set international standards for anti-money laundering (AML) and combating the financing of terrorism (CFT). The following principles are relevant to interpretation of this standard alongside other IFSB standards, and standards of other international standard-setting bodies.

   a. This standard has been developed to provide overarching principles and supporting material for supervisors with responsibility for takāful. A number of existing IFSB standards provide guidance to RSAs on the regulation and supervision of Islamic financial services and remain applicable to takāful where that is within their scope. In general, other IFSB standards concerning takāful are expected to be compatible with the principles, standards and guidance material set out in this standard.

   b. Supervisory theory, business models and drafting practices evolve over time. Apparent inconsistencies may therefore emerge between this standard and other IFSB standards relevant to takāful. RSAs should seek
to resolve any such inconsistencies in a manner consistent with this standard and in the spirit of the objectives of takāful supervision in the jurisdiction concerned.

c. In this context, attention is drawn to IFSB-10: Guiding Principles on Sharīʻah Governance Systems for Institutions offering Islamic Financial Services, which applies across all sectors in respect of Sharīʻah governance systems (as defined in that standard). It recognises that Sharīʻah governance may take several forms, and that jurisdictions have adopted diverse approaches to it. In this standard, TCP 8: Sharīʻah Governance and other materials relating to Sharīʻah governance are prepared within that context and accommodate whichever Sharīʻah governance arrangements consistent with IFSB-10 may apply in an institution or jurisdiction.

d. TCP 22: Anti-Money Laundering and Combating the Financing of Terrorism is intended to be consistent with the FATF recommendations but is not designed to secure compliance with those recommendations. Furthermore, the application of both TCP 22 and TCP 21: Countering Fraud in Takāful is subject at all times to the constraints of applicable laws relating to AML/CFT in the one case and fraud in the second case and does not in any way require, authorise or condone actions or inaction in contravention of those laws.

1.6 Due Process

47. In line with IFSB Guidelines and Procedures for the Preparation of Standards and Guidance/Technical Notes, the formulation of the CPIFR-Takāful standard adheres to a rigorous due process. The IFSB Secretariat, to the best of its ability through various stages, determined that the material that is common ground between conventional and Islamic finance may involve only minimal risk that its application in any given jurisdiction will lead to Sharīʻah non-compliance.

48. In line with its mandate in advocating Sharīʻah compliance, the IFSB Sharīʻah Board's review has focused on those matters in the CPIFR-Takāful standard that address Islamic finance specificities. Hence, material in the TCPs that is deemed applicable to both conventional and Islamic finance ("common ground material") has not been subjected to review by the Sharīʻah Board. It is ultimately the responsibility of supervisors to consider whether any common ground material is observed in a manner that respects the understanding of Shariʻah in their jurisdiction.

1.7 Observance Date

49. To encourage consistency in the observance of IFSB standards across jurisdictions, it is recommended that RSAs observe the standard in their jurisdictions effective from January 2024 onwards, taking into account an
adequate preparatory period starting from the issuance date of this standard for the standard to be reflected into national regulations and guidelines and, where applicable, in supervisory practices. RSAs are encouraged to give effect to the standard earlier than this date where they are able to do so.

50. The level of observance of the standard in a particular jurisdiction may be dependent upon, and be without prejudice to, the general legal framework of that jurisdiction.
SECTION 2: TAKÄFUL CORE PRINCIPLES

TCP 1: OBJECTIVES, POWERS AND RESPONSIBILITIES OF THE SUPERVISOR

Each authority responsible for takāful supervision, its powers and the objectives of takāful supervision are clearly defined.

Introductory Guidance

1.0.1 Publicly defined objectives foster transparency. Based on this, government, legislatures and other stakeholders, including takāful industry participants and consumers, can form expectations about takāful supervision and assess how well the supervisor is achieving its objectives and fulfilling its responsibilities.

1.0.2 Responsibilities and objectives of the supervisor should be stable over time. However, when those responsibilities and objectives are updated periodically, it should be done in a manner that avoids creating instability, as a stable business environment is important for the insurance sector and consumer confidence. Objectives and key aspects of the supervisor responsibilities should be defined in primary legislation to the extent that it needs the effect of law. Aspects that should undergo frequent updating due to changing circumstances should be supplemented as needed with updated legally enforceable rules and guidance.

1.1 Primary legislation clearly defines the authority (or authorities) responsible for takāful supervision.

1.1.1 Primary legislation should clearly define responsibilities of each authority involved in takāful supervision at both the TU level and the group-wide level.

1.1.2 Institutional frameworks for takāful supervision vary across jurisdictions. For example, there may be separate authorities for prudential and market conduct supervision, for macro- and micro-prudential supervision, for licensing and ongoing supervision, and resolution.

1.1.3 Where there are multiple authorities responsible for takāful supervision, the institutional framework, the main responsibilities of the respective authorities and a basis for cooperation and coordination should be clearly set out in primary legislation.

1.2 Primary legislation clearly determines the objectives of takāful supervision and these include at least to:

- protect takāful participants;
- promote the maintenance of a fair, safe and stable takāful market; and
- contribute to financial stability.
1.2.1 The precise supervisory objectives and their respective priority may vary by jurisdiction depending on the level of development of the *takāful* markets, market conditions and consumers. Supervisory objectives could also include promoting *takāful* market development, financial inclusion, financial consumer education, and contributing to fighting financial crime.

1.2.2 The promotion of fairness, safety and stability in *takāful* markets includes the maintenance of public confidence in the Shari‘ah integrity of *takāful* institutions and products.

1.2.3 The *takāful* participants to be considered in defining supervisory objectives include past, present and future *takāful* participants.

1.2.4 Depending on the evolution of the jurisdiction’s insurance or financial markets, the supervisor may emphasise temporarily one or more of the objectives. Regardless, the supervisor should take into account the other objectives in fulfilling its function. In such circumstances, this should be explained to stakeholders, including *takāful* industry participants, consumers and the general public.

1.3 Primary legislation gives the supervisor adequate powers to meet its responsibilities and objectives.

1.3.1 Primary legislation should give the supervisor the necessary powers to achieve its responsibilities and objectives, and the ability to take supervisory action adequately. The supervisor should have the powers needed to implement a framework for effective *takāful* supervision, which is described by the TCPs in general.

1.3.2 Legislation should clearly address TU and group-wide supervision, providing the supervisor with sufficient powers to achieve the respective responsibilities and objectives.

1.3.3 The supervisor should have sufficient powers in place to perform the role of a group-wide supervisor, including coordination and collaboration with other relevant supervisors. Additionally, the legislation should empower the supervisor of a TU which is part of a group to contribute to the supervision of that group on a group-wide basis.

1.4 The supervisor initiates or proposes changes in legislation where current responsibilities, objectives or powers are not sufficient to meet the intended supervisory outcomes.

1.4.1 It is important that supervisory responsibilities, objectives and powers are aligned with actual challenges faced by the *takāful* market to effectively protect *takāful* participants, maintain a fair, safe and stable *takāful* market and contribute to financial stability.

1.4.2 Market changes can mean that the legislation is no longer adequate for the supervisor to achieve its intended outcomes. The supervisor may identify
changes in the economy, society or business environment in general that affect takāful supervision that are not currently or sufficiently addressed by legislation. When the supervisory outcomes may not be achieved with the current legislation, the supervisor should initiate or propose changes in legislation.

1.4.3 If supervisory responsibilities, objectives or powers assigned by primary legislation become obsolete, the supervisor should initiate or propose changes to the legislation.

TCP 2: SUPERVISOR
The supervisor is operationally independent, accountable and transparent in the exercise of its responsibilities and powers, and has adequate resources to discharge its responsibilities.

Introductory Guidance

2.0.1 Operational independence, accountability and transparency by the supervisor contribute to the legitimacy and credibility of the supervisory process. As explained in this introductory guidance, the three concepts of independence, accountability and transparency are closely interconnected and mutually dependent.

2.0.2 Operational independence means the supervisor should be able to take actions and make decisions in the exercise of its supervisory responsibilities without interference from any part of the government, including other governmental bodies, the legislature, and the takāful sector. The supervisor should be able to carry out the supervisory process, take supervisory measures and impose sanctions as it deems necessary to fulfill its objectives. However, this independence should be balanced with accountability.

2.0.3 The supervisor should be accountable for the actions it takes in the exercise of its supervisory responsibilities to the government, including other governmental bodies and the legislature, which delegated various responsibilities to the supervisor, as well as to those it supervises and the public at large. Accountability means that the supervisor operates within the bounds of its delegated authority, in a fair and equitable manner that is open to scrutiny and review by the government and the public, and that the actions of the supervisor may be challenged as part of a judicial appeal process. Strong internal governance processes, sufficient and skilled human resources and maintenance of high standards of integrity and professionalism underpin the accountability of the supervisor.

2.0.4 Transparency reinforces accountability. Transparency increases the predictability of supervision and shapes the expectations of supervised entities, which enhances supervisory effectiveness. For these reasons,
supervisory requirements, supervisory processes as well as information about the supervisor’s responsibilities should be publicly disclosed, in a manner consistent with any confidentiality requirements imposed on the supervisor.

2.0.5 The structures of supervisors vary across jurisdictions. For example, a supervisor can be structured as a separate independent entity governed by a board of directors, as a commission or as a body overseen by one appointed individual. No one single structure is appropriate for all supervisors. Regardless of their structure, all supervisors should have processes and safeguards that allow them to be operationally independent, accountable and transparent.

2.0.6 Given the differences in structures between supervisors, in this TCP, “governing body” refers to the body of individuals that exercises oversight of the supervisory organisation, such as a board or commission, or in the case of a supervisor overseen by an appointed individual, to that individual. The “head of the supervisor” refers to the individual who is an employee of the supervisor and who leads the management team and exercises full management responsibility for the day-to-day functioning and decisions of the supervisor. The head of the supervisor may or may not also be a member of the governing body.

Independence

2.1 The supervisor is operationally independent and free from undue government or industry interference that compromises that independence.

2.1.1 Operational independence of the supervisor includes having the discretion to allocate its resources, including financial and human resources, and to carry out the supervisory process in accordance with its objectives and the risks the supervisor perceives. Having this discretion, which underpins operational independence, should be recognised in primary legislation.

2.1.2 The supervisor should be financed in a manner that does not undermine its independence. A wide variety of financing models exist, such as financing by government, levies imposed on supervised entities and combinations thereof. To help ensure the supervisor’s independence is not compromised, the method in which it is financed should be stable, predictable and transparent, and prevent interference from its funding source.

2.1.3 The institutional relationships and accountability frameworks between the supervisor and the government should be clearly defined in legislation. It is important to specify the circumstances and processes for sharing information, consultation or approval between the supervisor and the government. This may include establishing what information should be provided, how each entity should consult on matters of mutual interest and
when approval from relevant authorities is necessary. The daily operations of the supervisor should not be subject to consultation with or approval by the government. In exceptional circumstances, the supervisor may choose to consult with the government in relation to a supervisory decision where there are major socio-economic implications of that decision.

2.1.4 In addition to independence from the government, the supervisor should not permit excessively close relationships, or even the appearance thereof, with industry participants – in particular, supervised entities. Such relationships can compromise the supervisor’s ability to enforce the law strictly or to control the behaviour of supervised entities as intended by law. These relationships can also lead the supervisor to make policy or operational decisions to benefit supervised entities, whether a particular entity or supervised entities as a whole, rather than in furtherance of its supervisory objectives. The supervisor’s policies – for example, post-employment, anti-corruption and accountability in decision making – should seek to avoid such close relationships.

2.1.5 The legislation should define the responsibilities of the governing body. In cases where there are industry representatives or elected officials or government employees on the governing body of the supervisor, the composition of the governing body should be sufficiently diverse to prevent such representatives from controlling the supervisor.

2.1.6 The supervisor’s staff and members of its governing body can also experience pressures that could compromise their independence. Generally, the staff of the supervisor should not hold any consultancies, directorships or financial interests, expect any future benefit from, or be involved in any capacity in the entities it supervises, other than in a supervisory role or as a customer, and should not accept gifts or hospitality from these entities in excess of a low monetary value. The supervisor should have policies and processes or a code of conduct to avoid or manage real, potential or perceived conflicts of interests. The supervisor should require its staff and members of its governing body to report conflicts of interests. Staff and members of the governing body of the supervisor should exclude themselves from decisions where they have a conflict of interest.

2.2 Legislation governing the supervisor provides the necessary legal protection from legal action against the supervisor and its staff for actions taken in good faith while discharging their duties. In addition, the supervisor’s staff is adequately protected against the costs of defending their actions.

2.2.1 Having necessary legal protection from legal action promotes the independence of the supervisor by enabling its staff to make decisions and take action against a regulated legal entity even though such action or decision may be contested by that entity.

2.2.2 In this context, legislation should protect the supervisor and its staff from criminal or civil liability for decisions made and actions taken in the course
of discharging their supervisory responsibilities, provided that the action or
decision was not taken in bad faith or illegally.

2.3 Procedures regarding the appointment and dismissal of the head of the
supervisor and members of its governing body (if such a governing body exists)
are transparent.

2.3.1 Public procedures regarding the appointment and dismissal of the head of
the supervisor enhance independence, as they limit the potential for
government interference in the management of the supervisor. Those
procedures should be codified in legislation.

2.3.2 Those procedures should disclose, for example, who appoints the head of
the supervisor and members of the governing body, the length of those
appointments and the reasons for which the head of the supervisor or
members of the governing body can be dismissed before the end of their
term, if applicable.

2.3.3 Legislation should disclose the general criteria for appointing members of
a governing body, including that they possess relevant qualifications,
knowledge and experience to oversee the activities of the supervisor, as
well as the mechanism for their remuneration (e.g. salary, daily allowance
or voluntary work). The procedures regarding the appointment of the
members of the governing body should result in a balance of skills,
knowledge and experience amongst the members of the governing body
as a whole.

Accountability

2.4 The supervisor has effective internal governance structures, processes and
procedures to preserve the integrity of its actions and decisions and to enable
it to account to its stakeholders.

2.4.1 A well-defined internal governance structure and strong internal
governance processes support the accountability and integrity of the
supervisor. The supervisor’s internal governance includes its
organisational structure and management arrangements, lines of
responsibility, and systems of risk management and internal controls. In
this context, “integrity” refers to the supervisor always acting with probity,
respectability and lawfulness, and within the bounds of its delegated
authority.

2.4.2 Regardless of the supervisor’s governance structure, the responsibilities
of the governing body, the responsibilities of senior management,
communication channels and decision-making authorities, including
delegation thereof, should be documented in writing to facilitate
compliance with internal controls, including proper authorisation of actions
taken by or on behalf of the supervisor. In addition, well-defined
communication channels help ensure prompt escalation of significant issues to appropriate levels within the supervisor.

2.4.3 The supervisor should have a process to develop and implement a strategic plan that sets out its goals and priorities, given the responsibilities and objectives assigned to it by legislation. Such a plan should cover a specific period of time, such as two or three years. The supervisor should report on its performance against that plan to the government and other stakeholders, including insurance industry participants, consumers and the general public.

2.4.4 The supervisor should identify the individual or group of individuals responsible for the implementation and review of the internal governance arrangements. The internal governance processes and procedures should be subject to regular independent review – for example, by an internal audit function or a public auditor.

2.5 The supervisor applies requirements and supervisory procedures consistently and equitably.

2.5.1 The supervisor should have internal mechanisms to help ensure that it is consistent in the actions and decisions it takes.

2.5.2 Cases where circumstances are similar should lead the supervisor to take similar actions or decisions. Actions taken in a particular case in the past should be considered in new cases where the circumstances are similar, unless a change in the requirements or supervisory procedures occurred in the time between the two cases.

2.6 There are processes to appeal against supervisory decisions which do not unduly impede the ability of the supervisor to make timely interventions in order to protect policyholders’ interests or contribute to financial stability.

2.6.1 Procedural fairness enhances public confidence in the supervisory process. Parties subject to a decision made by the supervisor should be able to receive the written reasons for the decision and to appeal the decision to an impartial review body or tribunal. The manner in which the supervisor’s decision could be subject to judicial review, or in which decisions can be appealed, should be defined and transparent, and be included in the notification of the decision.

2.6.2 The existence of an appeal or review mechanism helps ensure that the supervisor’s decisions are made within the law as consistently as possible and are well reasoned. Appeal processes should be specific and balanced to preserve supervisory independence and effectiveness. However, these processes should allow the supervisor to exercise its powers quickly in cases where expeditious action is required. In certain cases, these processes may provide that the decision of the supervisor remains in force until the appeal or review mechanism has produced a final decision on the appeal, unless otherwise ordered by a court.
2.7 The supervisor, including its staff and any third party acting on its behalf (presently or in the past), are required by legislation to protect confidential information in the possession of the supervisor.

2.7.1 The type of information that the supervisor is required to keep confidential should be specified in legislation. Generally, any non-public information received relating to a supervised entity would be considered confidential, as well as information received from another supervisor (see TCP 3: *Information Sharing and Confidentiality Requirements*). Legislation should also specify the circumstances under which the supervisor is allowed to disclose confidential information and to whom it can be disclosed.

2.7.2 The supervisor should protect confidential information. Safeguards should apply to information maintained in any format, including in physical form as well as electronic. The supervisor should assess the sensitivity of various categories of information in its possession, and identify the appropriate data protection requirements applicable to each category, including the duration of the retention period for information in each category.

2.7.3 The supervisor and its staff, including former staff, and all persons acting on its behalf (presently or in the past) should be liable to penalties for unlawful access to, use of, or disclosure of, confidential information. This includes any outside experts hired by the supervisor and persons to which the supervisor outsourced any supervisory function. The penalties for such conduct should be specified in legislation and may include disciplinary actions, up to and including termination of employment, and criminal or legal proceedings. The duty of confidentiality should survive the termination of employment of a staff member or other third party engaged by the supervisor.

**Transparency**

2.8 The supervisor is transparent to the public, supervised entities and the government about how it exercises its responsibilities.

2.8.1 Transparency reinforces accountability of supervisors. The supervisor should publish information about itself and the *takāful* sector, including:

- its objectives and responsibilities;
- its goals and priorities for the future;
- its activities in light of its goals and priorities in the previous year;
- its resources, including human, technological and financial;
- data and analysis about the state of the *takāful* sector; and
- supervisory measures taken in relation to problem or failed TUs, subject to confidentiality considerations and in so far as it does not jeopardise other supervisory objectives or prejudice another case pending before the supervisor.
2.8.2 The supervisor should seek to publish a report at least annually that contains the elements listed above as well as its audited financial statements. This type of report is a key document by which a supervisor accounts to its stakeholders.

2.9 The supervisor publishes its requirements, policies and supervisory procedures. The supervisor consults publicly on significant changes that it makes to requirements, policies and supervisory procedures.

2.9.1 The supervisor publishes and regularly reviews requirements, policies and supervisory procedures to ensure they remain appropriate for the characteristics of the industry, emerging risks and evolving international standards. Some requirements may be contained in primary legislation, while others may be contained in instruments issued by the supervisor, such as guidance and industry advice. The supervisor should ensure these instruments are made available to the public – for example, on the supervisor’s website.

2.9.2 A critical element of transparency is for the supervisor to provide the opportunity for meaningful public consultation on proposed requirements and supervisory procedures. Meaningful public consultation benefits from participation by a diversity of stakeholders. Consequently, the supervisor should have methods in place to encourage and solicit stakeholder participation.

2.9.3 The supervisor should have written procedures on the types of documents that are subject to public consultation as well as the process and timelines for consultation. Some documents used in the supervisory process may not be suitable for consultation, such as detailed procedural manuals that are used to guide staff of the supervisor in the performance of their day-to-day duties.

2.9.4 In some jurisdictions, the development and issuance of requirements may be outside of the control of the supervisor; for example, the power to enact legislation may be vested in another government body or supranational bodies that have a direct role in the legislation in force in their member countries. In such cases, the consultation process may also be outside the remit of the supervisor. To the extent possible, the supervisor should be involved in the development of the requirements – for example, by participating in consultations – and the supervisor should keep the public and the industry informed of proposed changes.

Resources

2.10 The supervisor has sufficient resources, including human, technological and financial resources, to enable it to conduct effective supervision.
2.10.1 The supervisor’s financial resources and staffing policies should enable it to attract and retain highly skilled, competent and experienced staff with the necessary professional qualifications, where required. The supervisor should have the ability to hire or contract the services of external experts when necessary.

2.10.2 In particular, the supervisor should be able to obtain expert advice, whether within its own organisation or externally from either professional practitioners or a recognised Sharī‘ah authority in its own jurisdiction, to enable it to understand matters relating to Sharī‘ah, relevant to the supervision of the takāful market.

2.10.3 The supervisor should have a process for regularly reviewing its human resources needs, the skills and experience of existing staff and its projected human resource requirements over the short to medium term.

2.10.4 This review could lead the supervisor to implement initiatives to bridge gaps in numbers and/or skills. These could include more flexible hiring policies or schemes for secondment of staff from industry or other supervisory authorities within the jurisdiction or internationally. These initiatives may help in providing access to specialist skills on a temporary basis. Secondments for supervisory staff to industry or other supervisory authorities enhance the skills and experience of staff particularly to better understand industry practices. When implementing such initiatives, the supervisor should have safeguards in place to avoid conflicts of interest and protect confidential information, such as by restricting access to certain information.

2.10.5 The supervisor should provide adequate training opportunities for its staff to ensure that their skills and supervisory practices remain up to date with evolving supervisory and regulatory developments and changes in the industry.

2.10.6 The technological resources available to the supervisor should enable supervisory staff to collect and store securely, quickly access, and efficiently analyse information about the entities it supervises.

2.11 Where the supervisor outsources supervisory activities to third parties, the supervisor:

• sets expectations for their role and work;
• monitors their performance;
• ensures their independence from the supervised entity or any other related party; and
• subjects them to the same confidentiality rules and professional standards as the staff of the supervisor.

2.11.1 Outsourcing of selected supervisory activities to third parties can complement the supervisor’s resources with valuable expertise. However, supervisory activities are primarily the responsibility of the supervisor. The supervisor should retain accountability for and oversight of any outsourced...
activities to the same degree as non-outsourced activities. Outsourcing should not adversely affect the supervisor’s ability to conduct effective supervision or meet its objectives.

2.11.2 The process used to select third-party providers should be fair, open and transparent. All qualified third-party providers should have equal access to information regarding the process. Prior to engaging a third party, the supervisor should assess the proposed provider’s competence and experience and the safeguards for the handling of data, including treatment of confidential information. The decision to select a provider should be made free from conflicts of interest, or where such conflicts cannot be avoided, they should be managed.

2.11.3 A written agreement should govern the relationship between the supervisor and the third-party provider. The agreement should describe all material aspects of the outsourcing arrangement, including the services to be provided, remuneration of the third-party provider, resolution of disputes and procedures governing the subcontracting of services.

TCP 3: INFORMATION SHARING AND CONFIDENTIALITY REQUIREMENTS
The supervisor obtains information from, and shares information with, relevant supervisors and authorities subject to confidentiality, purpose and use requirements.

3.1 The supervisor requests information, including non-public information, from relevant supervisors and authorities with respect to TUs.

3.1.1 Information requested by a supervisor from a relevant supervisor or authority may include:
- information on strategy, business activities and business models, including the Islamic insurance model or models used (e.g. wakālah, waqf, cooperative or participation) and including prospective and recent acquisitions or disposals of Islamic or conventional insurance business;
- financial data relating to the TU, including at the level of its segregated funds and transactions between them;
- organisational structure, both legal and management structure, including organisational arrangements for Shari`ah governance;
- information on the management and operational systems and controls used by the TO;
- information on individuals holding positions of responsibility in TOs, such as board members, senior management, members of the Shari`ah board, key persons in control functions and significant owners;
- information on individuals or TOs involved, or suspected of being involved, in criminal activities;
- information on any failures to comply with supervisory requirements, regulatory investigations and reviews, and on any restrictions imposed on the business activities of TUs;
• information on any incidents of failure to comply with Shari`ah requirements relevant to the takāful business;
• information concerning regulated entities related to the insurance group, whether undertaking takāful business, conventional insurance business or other financial business which is subject to regulation, and information concerning non-regulated entities related to the insurance group such as service companies or holding companies;
• specific information requested and gathered from a regulated entity; and
• reporting information within groups to meet group supervisory requirements, including subsidiaries and non-regulated holding companies.

3.1.2 Relevant supervisors and authorities, whether in the same or a different jurisdiction, may include:
• other insurance supervisors;
• supervisors responsible for banks and other credit institutions;
• supervisors responsible for investments, securities, pensions, financial markets and other sectors;
• authorities responsible for religious matters such as waqf, where relevant;
• authorities responsible for the recovery or resolution of TUs;
• authorities responsible for anti-money laundering or combating the financing of terrorism; and
• law enforcement agencies.

3.1.3 Financial services supervisors referred to in Guidance paragraph 3.1.2 may be those with responsibilities for conventional financial services, for Islamic financial services, or for both.

3.2 The supervisor shares information, including non-public information, with relevant supervisors and authorities at its sole discretion and subject to appropriate safeguards.

Agreements on Information Sharing

3.2.1 Supervisors and authorities are responsible for ensuring the safe handling of confidential information. Although the existence of an agreement or understanding on providing requested information may not be a prerequisite for sharing information, the supervisor is encouraged to use agreements, including memoranda of understanding (MoUs), to facilitate information sharing between relevant supervisors and authorities. Such agreements are important to information sharing among supervisors and authorities to establish a framework to facilitate the efficient exchange of confidential information and document the types of information that may be shared as well as the terms and conditions under which the information can be shared and passed on to other relevant supervisors and authorities. Such agreements may be distinguishable from coordination agreements used in supervisory colleges (see TCP 25: Supervisory Cooperation and Coordination).
3.2.2 The supervisor should use bilateral or multilateral agreements to facilitate information sharing because they provide the basis for a two-way flow of information and the basis for confidential treatment of the information shared. The IAIS MMoU is an example of a multilateral memorandum of understanding for cooperation and exchange of information between supervisors related to the supervision of insurance legal entities and insurance groups. All signatories to the IAIS MMoU undergo a validation of their laws and regulations to demonstrate compliance with the MMoU’s strict confidentiality regime. For this reason, if all relevant parties are signatories to the IAIS MMoU, it is the preferred framework for multilateral information exchange.

3.2.3 Supervisors responsible for supervision of both conventional insurance and takāful should observe information-sharing obligations where the conditions specified in agreements are met.

Information Sharing in Supervisory Colleges

3.2.4 Supervisory colleges can provide a framework for supervisory cooperation and crisis management in which information sharing between involved supervisors occurs on an ongoing basis.

3.2.5 Information sharing is particularly important for the operation of a supervisory college. For a supervisory college to be effective there needs to be mutual trust and confidence among supervisors, particularly in relation to exchange and protection of confidential information.

3.2.6 Each member of the college should take measures necessary to avoid the unintentional divulgence of information or the unauthorised release of confidential information. It is important that appropriate information exchange agreements or other arrangements are in place between the members of the supervisory college to ensure that information can be exchanged in a secure environment.

3.2.7 Where confidential information exchanged within a supervisory college is communicated to relevant supervisors or authorities who are not involved in the college, supervisors should:

- have a formal mechanism in place between the group-wide supervisor and the other supervisors or authorities to ensure the protection of the confidential information. Such mechanisms could be included in the relevant information-sharing agreements; and
- obtain the prior consent of the supervisor having provided such information.

3.3 The supervisor requesting confidential information (the requesting supervisor) has a legitimate interest and valid supervisory purpose related to the fulfilment of its supervisory functions in seeking information from another relevant supervisor or authority.
3.3.1 A legitimate interest is derived from the powers and responsibilities the requesting supervisor has in relation to the subject matter of the request. For example:

- if the requesting supervisor only has the power and responsibility to supervise intermediaries and not TUs, it may not have a legitimate interest in requesting information relating to a TU; or
- if the requesting supervisor requests information relating to a TU that has no current or planned operations or other connections to the requesting supervisor’s jurisdiction, it may not have a legitimate interest in requesting such information.

3.3.2 A valid supervisory purpose is relevant to the requesting authority’s performance of a supervisory task. Valid supervisory purposes may include information requested for the purposes of:

- licensing;
- suitability criteria;
- intra-group transactions such as loans and extensions of credit, parental guarantees, management agreements, service contracts, cost-sharing arrangements, retakāful or reinsurance agreements, dividends and distributions;
- prevention of financial crime, such as fraud, AML or CFT;
- ongoing supervision, including preventive and corrective measures and sanctions; and
- exit from the market and resolution.

3.3.3 A supervisor may voluntarily provide information to other relevant supervisors so as to better enable the supervisor’s fulfilment of their supervisory functions. In such cases, the supervisor providing information should adhere to the same requirements as though the information had been requested by a requesting supervisor.

3.4 The supervisor that has received a request for confidential information (the requested supervisor) from another relevant supervisor or authority:

- assesses each request for information on a case-by-case basis; and
- responds to requests in a timely and comprehensive manner.

3.4.1 In principle, the requested supervisor is expected to share information with a requesting supervisor with a legitimate interest and for a valid supervisory purpose.

3.4.2 In deciding whether and to what extent to fulfil a request for information, the requested supervisor may take into account matters including:

- the nature of the information to be provided;
- the purpose for which the information will be used;
- the ability of the requesting supervisor or authority to maintain the confidentiality of any information received, taking account of the IAIS MMOU or other existing agreements in each jurisdiction;
- whether, in the context of supervisory college or otherwise, the request is covered by a coordination agreement;
• whether it would be contrary to the interest of the jurisdiction of the requested supervisor; and
• relevant laws and regulations in each jurisdiction (in particular, those relating to confidentiality and professional secrecy, data protection and privacy, and procedural fairness).

3.4 While requests for information should normally be made in writing, the requested supervisor should not insist on written requests in an emergency situation, and should not unreasonably delay a response to an oral request for information made for a valid supervisory purpose by a requesting supervisor.

3.4.4 The requested supervisor may receive a request for information which is not already in their possession. In such circumstances, the requested supervisor should, if it considers it reasonable, obtain that information from the TO or other entities from which it has the power to obtain information.

3.4.5 If the requested supervisor denies a request, it should explain its reason for the denial to the requesting supervisor or authority.

3.4.6 Lack of strict reciprocity should not be used by the requested supervisor as the reason for not sharing information that would otherwise be appropriate to share, particularly in an emergency or other crisis situation. Strict reciprocity in terms of the level, format and detailed characteristics of information requested is not required.

3.5 The requesting supervisor uses confidential information received from the requested supervisor or authority only for the purposes specified when the information was requested. Unless otherwise agreed, before using the information for another purpose or passing it on to others, the requesting supervisor obtains agreement of the requested supervisor or authority.

3.5.1 The requesting supervisor should specify the intended purposes of the information sought. Additionally, MoUs may address purposes for which the requested information may be used by the requesting supervisor.

3.5.2 The requesting supervisor first obtains agreement with the requested supervisor or authority before passing on requested information. Supervisors and authorities are encouraged to request information directly from the requested supervisor, rather than from the requesting supervisor, to provide an opportunity for direct dialogue and further consultation. Requesting supervisors should ensure that appropriate confidentiality requirements are in place and the information is only passed on to another relevant supervisor or authority with a legitimate interest and – in case of a supervisory authority – for valid supervisory purposes.

3.5.3 There are specified circumstances within the IAIS MMoU where signatories are expected to consent to the passing on of information to other relevant supervisors and authorities. This includes situations where passing on information will assist:
other IAIS MMoU signatories in the fulfilment of their supervisory functions; and
other relevant domestic financial sector bodies such as central banks, law enforcement agencies, relevant courts and other authorities (see Annex B of the IAIS MMoU).

3.5.4 Conditions imposed by the requested supervisor on the passing on of information to third parties should not prevent the requesting supervisor or authority from being able to use the information for its own valid supervisory purposes.

3.6 In the event the requesting supervisor has received notice of proceedings, which may legally compel it to disclose confidential information which it has received from the requested supervisor, the requesting supervisor:

• to the extent permitted by law, promptly notifies the requested supervisor; and
• where consent to disclosure is not given, uses all reasonable means to resist the demand and to protect the confidentiality of the information.

3.6.1 Where allowed by the laws and practices of the jurisdiction, a requesting supervisor required to disclose confidential information by legal compulsion should place, or seek to place, protections from disclosure on that information. Such protections could include:

• a protective order placing restrictions on use or further distribution of the confidential information; or
• limitations on the means and location of the disclosure of the confidential information.

TCP 4: LICENSING

A legal entity which intends to engage in takāful activities must be licensed before it can operate within a jurisdiction. The requirements and procedures for licensing must be clear, objective and public, and be consistently applied.

Introductory Guidance

4.0.1 Licensing contributes to efficiency and stability in the takāful sector. Strict conditions governing the formal approval through licensing of TOs and TUs are necessary to protect consumers. The relevant licensing criteria should be applied to prospective entrants consistently to promote a level playing field at point of admission to the takāful sector. Licensing requirements and procedures should not be used inappropriately to prevent or unduly delay access to the market.

4.0.2 The role of the supervisor in licensing is to assess whether TUs are able to fulfil their obligations to takāful participants on an ongoing basis. The licensing procedure is the first step towards achieving this objective.
Licensing is distinct from approval granted in terms of general domestic company, trade or commercial law. Apart from applying for a supervisory licence, other requirements pertaining to company, trade or commercial law should be met (e.g. filing incorporation documents or applying to the registrar of commerce).

**Licensing Requirements**

4.1  
**The takāful legislation:**
- includes a definition of *takāful* activities which are subject to licensing;
- prohibits unauthorised *takāful* activities;
- defines the permissible legal forms of domestic TUs;
- allocates the responsibility for issuing licences; and
- sets out the procedure and form of establishment by which foreign TUs are allowed to conduct *takāful* activities within the jurisdiction.

4.1.1  
Jurisdictions may decide to exclude some activities from the definition of *takāful* activities subject to licensing. Any such activities should be explicitly stated in the legislation. Jurisdictions may do this for various reasons, such as:
- the insured sums do not exceed certain amounts;
- losses are compensated by payments in kind;
- activities are pursued following the idea of solidarity between *takāful* participants (e.g. small mutuals, cooperatives and other community-based organisations, especially in the case of microinsurance); or
- the entities’ activities are limited to a certain geographical area, limited to a certain number or class of *takāful* participants and/or offer special types of cover such as products not offered by licensed domestic TUs.

4.1.2  
The reference to a basis of solidarity in Guidance paragraph 4.1.1 should not imply that *takāful* in general may be exempted from licensing notwithstanding that solidarity is an underlying principle of the *takāful* relationship. The exemption should be limited to small, affinity-based or community-based operations.

4.1.3  
Jurisdictions may also decide to exclude from the definition of *takāful* activities subject to licensing:
- activities that, as well as being *takāful*, are permitted regulated activities of a licensed Islamic bank or other Islamic financial services provider subject to regulation; or
- activities which are not held out as being performed on a Shari‘ah-compliant basis and are otherwise subject to financial services regulation (e.g. because they also constitute regulated activities of a conventional insurer and are not marketed as Islamic insurance). Supervisors should, however, be aware of the risk of regulatory arbitrage where similar activities are subject to different supervisory regimes.
4.1.4 Given the principle that all entities engaged in *takāful* activities must be licensed, the exclusion of limited *takāful* activities from licensing requirements should give due regard to having appropriate alternative safeguards in place to protect *takāful* participants.

4.1.5 Similarly, jurisdictions may allow a simplified process for non-significant entities (e.g. limited geographic scope, limited size and limited lines of business) for the purposes of licensing. In such situations, the legislation should state clearly the applicability, requirements and process for such authorisation.

4.1.6 In jurisdictions where an authority other than the *takāful* supervisor is responsible for issuing licences, the *takāful* supervisor should be able to give input and recommend conditions or restrictions (including refusal) on a licence where appropriate to the licensing authority.

4.2 A jurisdiction controls through licensing which entities are allowed to conduct *takāful* activities within its jurisdiction.

4.2.1 Entities should neither be allowed to present themselves nor act as licensed TOs or TUs without or before having been granted a licence.

4.2.2 The supervisor should be able to refuse to license a legal entity under *takāful* (rather than conventional insurance) legislation, or be able to prevent it from using a name or advertising material that implies that its business is conducted on an Islamic basis, if the supervisor is satisfied on reasonable grounds, following due enquiry, that the business is not generally accepted in that jurisdiction to be conducted on an Islamic basis and the supervisor considers that consumers would be misled.

4.2.3 Depending on the legal forms that are permitted in a jurisdiction, foreign TUs may be allowed to conduct *takāful* activities within the jurisdiction by way of a local branch or subsidiary or on a cross-border provision of services basis. A subsidiary is a domestically established legal entity that needs to be licensed. A branch is not separate from the TU, and can be established in a jurisdiction other than the TU's home jurisdiction. A host jurisdiction may require that branches of foreign TUs be licensed or otherwise authorised by the host supervisor. Cross-border provision of services does not require a local establishment but may require authorisation from the host supervisor.

4.2.4 In some regions, a number of jurisdictions have agreed to a system of passporting as a manner of acknowledging each other’s licences. This provides the opportunity for TUs established in one of the jurisdictions to open branches or provide *takāful* services across borders on the basis of their home jurisdiction authorisation to conduct *takāful* activities. Where a foreign TU may be allowed to operate through a branch or cross-border provision of services without a licence or other authorisation from the host supervisor, it is important that bilateral or multilateral agreements are in place which ensure that the TU:
• is subject to supervision in its home jurisdiction which has been recognized as adequate by the host jurisdiction; and
• may be subject to sanction or other supervisory measures if it does not meet the legal provisions of the host jurisdiction. In such circumstances, the home supervisor should be informed.

4.3 Licensing requirements and procedures are clear, objective and public, and are consistently applied. The applicant is required at least to:
- have sound business and financial plans;
- have a corporate or group structure that does not hinder effective supervision;
- establish that the applicant's board members, both individually and collectively, senior management, Shari`ah board members, both individually and collectively, key persons in control functions and significant owners are suitable;
- have an appropriate governance framework, including appropriate Shari`ah governance; and
- satisfy capital requirements.

4.3.1 In addition to being publicly available, licensing requirements should also be easily accessible. Supervisors should issue guidelines on how to file an application for a licence, which include advice on the required format of documents and the expected time it would take to process an application upon the receipt of all relevant documents.

4.3.2 Supervisors should assess the applicant’s business and financial plans to ascertain that the proposed business lines will be soundly managed and adequately capitalised. Business and financial plans should be projected for a minimum of three years by the applicant and include information such as the products to be offered, distribution methods and channels to be used, risk profile, projected setting-up and development costs by business line, capital requirements and solvency margins. Information regarding takāful and retakāful should also be provided.

4.3.3 Supervisors should understand the model of Islamic insurance proposed to be adopted by the applicant (e.g. wakālah, waqf, cooperative, participation), and ascertain that the business and financial plans presented are consistent with that model. Applicants should, where required, provide evidence that the model proposed is permitted in the jurisdiction.

4.3.4 Where the applicant is part of a group, the applicant should submit its corporate and group structure, indicating all of the material entities within the group (including TUs, insurance legal entities and other entities, including non-regulated entities). Information on the type of related party transactions and/or relationships between all material entities within the group should also be provided.
4.3.5 The applicant should also provide information to demonstrate the appropriateness of its systems of risk management and internal controls, including contracts with affiliates, outsourcing arrangements, information technology systems, policies and processes.

4.3.6 Applicants should provide evidence that the proposed governance, risk management and internal control arrangements adequately address risks associated with the model of Islamic insurance proposed to be adopted by the applicant (e.g. fiduciary and contagion risks associated with segregation of funds) and that the proposed Sharī`ah governance arrangements adequately address risk of Sharī`ah non-compliance.

4.3.7 If applying to be licensed to underwrite both family takāful business and general takāful business (where such is allowed), the applicant should demonstrate to the satisfaction of the supervisor that its systems of risk management and internal controls are adequate to manage the risks separately for each business stream.

4.3.8 If the applicant is a conventional insurer applying for a licence to operate a takāful window, the applicant should demonstrate to the satisfaction of the supervisor that its systems of governance, Sharī`ah governance, risk management and internal controls adequate to manage the risks of the window operation separately from the operations of the conventional insurer of which it is a part.

4.3.9 Further guidance on suitability, governance and capital requirements can be found in TCP 5: *Suitability of Persons*; TCP 7: *Corporate Governance*; TCP 9: *Risk Management and Internal Controls*; and TCP 17: *Capital Adequacy*.

4.3.10 Further guidance on Sharī`ah governance can be found in TCP 8: *Sha`rī ah Governance*.

**Requirements of the Supervisor**

4.4 The supervisor assesses applications, makes decisions and informs applicants of the decision within a reasonable time, which is clearly specified, and without undue delay.

4.4.1 The supervisor should require a legal entity to submit an application if it proposes to conduct takāful activities. The application should include information on the types of business to be written and contain all the documents and information required by the legislation to confirm that the licensing requirements are met.

4.4.2 In instances where the application is deemed not complete, the supervisor should inform the applicant without delay, and the applicant should be given the opportunity to provide additional information to complete the application.
4.4.3 In assessing the application, the supervisor could rely on audits by external bodies, actuarial reports, or (in the case of branches or foreign subsidiaries) the opinion of other supervisors. Supervisors should consider the reports or opinions from these various sources carefully and apply their own judgment in making the final decision on the application. Before placing reliance on reports from external auditors or actuaries, supervisors should consider:
  • whether the external auditors and actuaries have the necessary expertise and experience to perform the roles; and
  • their independence from the legal entity and the consideration they give to the protection of takāful participants’ interests.

4.4.4 The supervisor should make its assessment and finalise its decision within a reasonable time frame and without undue delay. A time period should be indicated to the applicant for the assessment procedure, commencing from the date on which all complete application documentation has been submitted to the supervisor. Within this period, the supervisor should decide on the acceptability of the application for a licence. However, this does not preclude the supervisor from conducting additional due diligence if necessary. If the supervisor has not come to a decision within the indicated time frame and the licence cannot be granted, the supervisor should communicate the reason for the delay to the applicant.

4.5 The supervisor refuses to issue a licence where the applicant does not meet the licensing requirements. Where the supervisor issues a licence, it imposes additional requirements, conditions or restrictions on an applicant where appropriate. If the licence is denied, conditional or restricted, the applicant is provided with an explanation.

4.5.1 In general, requirements, conditions or restrictions that are imposed on an applicant at the point of issue of the licence deal with the scope of activities that a TU is permitted to conduct or the nature of its customers (e.g. retail versus sophisticated customers). If necessary, the supervisor should impose additional requirements, conditions or restrictions on an applicant not only at the point of issue of the licence, but also as part of its ongoing supervision of the TU (see TCP 10: Supervisory Review and Reporting and TCP 11: Preventive Measures, Corrective Measures and Sanctions).

4.5.2 The denial of a licence, or conditions or restrictions on a licence, should be confirmed in writing to the applicant. The explanation should be provided to the applicant in a transparent manner. Supervisors should convey their concerns with regard to an applicant’s proposed takāful activities and explain the reasons for imposing licensing conditions or restrictions.

4.6 A licence clearly states its scope.

4.6.1 A licence should clearly state the classification of takāful activities that the TO or TU is licensed to conduct. Regarding classification, legislation
should categorise takāful business into types and classes of takāful (at least into family and general).

4.6.2 Before adding new classes of takāful business to the list of classes already granted to the TU, the supervisor should consider all of the above-mentioned licensing requirements, as applicable.

4.7 The supervisor publishes a complete list of licensed TUs and the scope of the licences granted.

4.7.1 The supervisor should publish the complete list of licensed TUs and clearly state the scope of licence that has been granted to each TU. This would provide clarity to the public as to which entities are licensed for specific classes of business.

4.7.2 If the conditions or restrictions to the licence would impact the public or any person dealing with the TU, the supervisor should either publish these conditions or restrictions or require the TU to disclose them accordingly. Conditions or restrictions that would impact the public could include, for example, the lines or classes of takāful business a TU is permitted to conduct.

Foreign Operations

4.8 In deciding whether, and if so on what basis, to license or continue to license a branch or subsidiary of a foreign TU in its jurisdiction, the supervisor consults the relevant supervisor(s) as necessary.

4.8.1 As part of the consultation, supervisors should use the modes available for supervisory cooperation – in particular, the ability to exchange information relevant for the application (e.g. check of suitability of directors and owners) with domestic or foreign authorities. The exchange of information may be governed by law, agreement or memorandum of understanding, especially if the information is deemed confidential. Having such arrangements in place is important so as not to unduly delay the processing of an application.

4.8.2 Before making a decision to grant the licence, the host supervisor should have an understanding of how the home supervisor supervises the TU on an ongoing basis.

4.8.3 Host supervisors should consult home supervisors on relevant aspects of any licensing proposal, but in any event they should always consider checking that the home supervisor of the TU has no objection before granting a licence. The home supervisor should assess the risks posed to the TU of establishing a TU in a foreign jurisdiction and highlight any material reservations or concerns to the host supervisor as soon as practicable. The host supervisor should inform the home supervisor of the
scope of the licence, including any restrictions or prohibitions imposed on
the licence.

4.8.4 Host supervisors should reject applications for a licence from foreign
to regulation and supervision in the home
ejurisdiction. In the case of joint ventures, if there is lack of clear parental
responsibility, the supervisor should reject such applications.

4.9 Where the TO of a TU is seeking for the TU to conduct cross-border takāful
activities without a physical presence in the jurisdiction of the host supervisor,
the host supervisor concerned consults the home supervisor, as necessary,
before allowing such activities.

4.9.1 Jurisdictions or regions may have a system or cooperation agreements in
place whereby such consultation is not necessary or required.

4.9.2 Information exchanged as part of a consultation should include:
• confirmation from the home supervisor that the TU is authorised to
conduct the proposed types of takāful activities; and
• confirmation from the home supervisor that the TU meets all the
takāful regulatory requirements in the home jurisdiction.

TCP 5: SUITABILITY OF PERSONS
The supervisor requires board members, senior management, key persons in
control functions and significant owners of a TO to be and remain suitable to
fulfil their respective roles.

5.1 Legislation identifies which persons are required to meet suitability
requirements. The legislation includes at least board members, senior
management, key persons in control functions and significant owners.

5.1.1 Members of the Sharī`ah board of a TO, or such other persons as bear
responsibility for Sharī`ah governance of that TO, should be required to
meet suitability requirements. Suitability requirements may also extend to
other individuals involved in aspects of the entity’s Sharī`ah governance –
for example, those responsible for performance of a Sharī`ah compliance
function or Sharī`ah audit function.

5.1.2 In this TCP, references to board members, senior management and key
persons in control functions include also the persons referred to in
Guidance paragraph 5.1.1.

5.1.3 Suitability requirements may extend to other individuals (e.g. financial
controllers and treasurers) to account for the roles of such individuals that
differ depending on the jurisdiction and the legal form and governance
structure of the TU.

5.2 The supervisor requires that in order to be suitable to fulfil their roles:
• board members (individually and collectively), senior management and key persons in control functions possess competence and integrity; and
• significant owners possess the necessary financial soundness and integrity.

Suitability Requirements for Board Members, Senior Management and Key Persons in Control Functions

5.2.1 Competence is demonstrated generally through the level of an individual's professional or formal qualifications and knowledge, skills and pertinent experience within the takāful and financial industries or other businesses. Competence also includes having the appropriate level of commitment to perform the role. Refer to TCP 7: Corporate Governance with regard to competence and commitment, and to TCP 9: Risk Management and Internal Controls with regard to control functions.

5.2.2 Integrity is demonstrated generally through character, personal behaviour and business conduct.

5.2.3 The supervisor should require the TO to take the necessary measures to ensure that these requirements are met by setting high internal standards of ethics and integrity, promoting sound corporate governance and requiring that these individuals have pertinent experience, and maintain a sufficient degree of knowledge and decision-making ability.

5.2.4 To ensure an appropriate level of suitability, board members, senior management and key persons in control functions should acquire, maintain and enhance their knowledge and skills to fulfil their roles – for example, by participating in induction and ongoing training on relevant issues. Sufficient time, budget and other resources should be dedicated for this purpose, including external expertise drawn upon as needed. More extensive efforts should be made to train those with more limited financial, regulatory or risk-related experience.

Suitability Requirements for Sharī`ah Board Members

5.2.5 The supervisor requires the TO to ensure that members of the Sharī`ah board possess and maintain adequate knowledge of Sharī`ah and its application to takāful and of the operation of takāful and other financial markets in the jurisdiction in question. Refer also to TCP 8: Sharī`ah Governance with regard to qualities necessary for the exercise of this function.

Suitability Requirements for Significant Owners

5.2.6 The necessary qualities of a significant owner relate at least to:
• financial soundness demonstrated by sources of financing/funding and future access to capital; and
• integrity demonstrated in personal or corporate behaviour.
5.3 The supervisor requires the TO to demonstrate initially, and on an ongoing basis, the suitability of board members, senior management, key persons in control functions and significant owners. The suitability requirements and the extent of review required by the supervisor depend on the person’s role.

5.3.1 The supervisor should assess the suitability of board members, senior management, key persons in control functions and significant owners of a TO (or, where appropriate, a TU) as part of the licensing procedure before the TU is permitted to operate (see TCP 4: Licensing).

5.3.2 The supervisor should assess the suitability of board members, senior management, key persons in control functions and significant owners of TOs either prior to changes in the positions or as soon as possible after appointment. The supervisor should also require the TO to perform internal suitability assessments of board members, senior management and key persons in control functions on an ongoing basis – for example, on an annual basis – or when there are changes in the circumstances of the individuals. The supervisor may require the TO to certify that it has conducted such assessments and demonstrate how it reached its conclusions.

5.3.3 With regard to control functions, the individual(s) to be assessed should be the key persons in control functions.

5.3.4 The supervisor should have sufficient and appropriate information to assess whether an individual meets suitability requirements. The information to be collected and the supervisor’s assessment of such information may differ, depending on the role.

5.3.5 For the purpose of the assessment, the supervisor should require the submission of a résumé or similar indicating the professional qualifications as well as previous and current positions and experience of the individual and any information necessary to assist in the assessment, such as:

- evidence that the individual has sufficient relevant knowledge and pertinent experience within the takāful and financial industries or other businesses; and
- evidence that the individual has the appropriate level of commitment to perform the role.

5.3.6 The application of suitability requirements relating to competence for board members, senior management and key persons in control functions of a TO may vary depending on the degree of their influence and on their roles. It is recognised that an individual considered competent for a particular position within a TO may not be considered competent for another position with different responsibilities or for a similar position within another TO. When assessing the competence of the board members, regard should be given to the respective duties allocated to individual members to ensure appropriate diversity of qualities, and to the effective functioning of the board as a whole.
In assessing the integrity of an individual board member, senior management, key person in control functions and significant owner, the supervisor should consider a variety of indicators such as:

- **Legal indicators**: These provide information on possible legal misconduct. Such indicators could include civil liability, criminal convictions or pending proceedings:
  - for breaches of law designed to protect members of the public from financial loss — e.g. dishonesty, or misappropriation of assets, embezzlement and other fraud or other criminal offences (including AML and CFT);
  - against the individual in their personal capacity;
  - against a legal entity in which the individual is or was a board member, a member of the senior management, a key person in control functions or a significant owner; or
  - incurred by the individual as a consequence of unpaid debts.

- **Financial indicators**: These provide information on possible financial misconduct, improper conduct in financial accounting, or negligence in decision making. Such indicators could include:
  - financial problems or bankruptcy in the individual’s private capacity; or
  - financial problems, bankruptcy or insolvency proceedings of a legal entity in which the individual is or was a board member, a member of the senior management or a key person in control functions.

- **Supervisory indicators**: These provide information gathered by or that comes to the attention of supervisors in the performance of their supervisory duties. These supervisors could also be authorities with supervisory responsibility in sectors other than takāful. Such indicators could include:
  - the withholding of information from public authorities or the submission of incorrect financial or other statements;
  - conduct-of-business transgressions;
  - prior refusal of regulatory approval for key positions;
  - preventive or corrective measures imposed (or pending) on entities in which the individual is or was a board member, a member of the senior management, or a key person in control functions; or
  - outcome of previous assessments of suitability of an individual, or sanctions or disciplinary actions taken (or pending) against that individual by another supervisor.

- **Other indicators**: These may provide other information that could reasonably be considered material for the assessment of the suitability of an individual. Examples include:
- suspension, dismissal or disqualification of the individual from a position as a board member or a member of the senior management of any company or organisation;
- disputes with previous employers concerning incorrect fulfilment of responsibilities or non-compliance with internal policies, including code of conduct, employment law or contract law;
- disciplinary action or measures taken against an individual by a professional organisation in which the individual is or was a member (e.g. actuaries, accountants or lawyers); or
- strength of character, such as the ability and willingness to challenge, as an indicator of a person’s integrity as well as competence to perform the respective role.

The presence of any one indicator may, but need not in and of itself, determine a person’s suitability. All relevant indicators, such as the pattern of behaviour, should be considered in a suitability assessment. Consideration should also be given to the lapse of time since a particular indicator occurred and its severity, as well as to the person’s subsequent conduct.

5.3.8 For significant owners, the supervisor sets out minimum standards of financial soundness. If the significant owner that is to be assessed is a legal person or a corporate entity, the supervisor should collect sufficient and appropriate information, such as:
- the nature and scope of its business;
- its ownership structure, where relevant;
- its source of finance/funding and future access to capital;
- the group structure, if applicable, and organisation chart; and
- other relevant factors.

5.3.9 In determining the financial soundness of significant owners, the supervisor should assess their source of financing/funding and future access to capital. To do so, the supervisor may consider financial indicators including the following.
- **Financial statements and exhibits:** If the significant owner is a legal person, financial statements may include annual financial statements; for a natural person, it may include financial information (such as tax accounts or personal wealth statements) that are reviewed by an independent public accountant.
- **Transactions and agreements:** For example: loans; investments; purchase, sale or exchange of securities or other assets; dividends and other distributions to shareholders; management agreements and service contracts; and tax allocation agreements.

5.3.10 Additionally, the supervisor should consider matters such as whether:
- significant owners understand their role as potential future sources of capital, if needed;
- there are any indicators that significant owners will not be able to meet their debts as they fall due;
• appropriate prudential solvency requirements are met if the significant owner is a financial institution;
• significant owners have been subject to any legally valid judgment, debt or order that remains outstanding or has not been satisfied within a reasonable period;
• significant owners have made arrangements with creditors, filed for bankruptcy, or been adjudged bankrupt or had assets sequestered; and
• significant owners have been able to provide the supervisor with a satisfactory credit reference.

The presence of any one indicator may, but need not in and of itself, determine a person's suitability. All relevant indicators, such as the pattern of behaviour, should be considered in a suitability assessment. If the significant owner is regulated by another supervisor, the suitability assessment done by the latter may be relied upon to the extent that this assessment reasonably meets the requirements of this standard.

5.4 The supervisor requires notification by TOs of any changes in board members, senior management, key persons in control functions and significant owners, and of any circumstances that may materially adversely affect the suitability of its board members, senior management, key persons in control functions and significant owners.

5.4.1 TOs should be required to report promptly any information gained about these persons that may materially affect their suitability – for example, if a board member is convicted of a financial crime. See guidance under Standard 5.3 for additional examples of indicators of circumstances that may materially affect the suitability of an individual.

5.5 The supervisor takes appropriate action to rectify the situation when board members, senior management and key persons in control functions or significant owners no longer meet suitability requirements.

5.5.1 The supervisor should impose measures in respect of board members, senior management and key persons in control functions who do not meet the suitability requirements. Examples of such measures include:
• requesting the TO to provide additional education, coaching or the use of external resources in order to achieve compliance with suitability requirements by an individual in a position as board member, member of the senior management or key person in control functions;
• preventing, delaying or revoking appointment of an individual in a position as board member, member of the senior management or key person in control functions;
• suspending, dismissing or disqualifying an individual in a position as a board member, senior management or key person in control function, either directly or by ordering the TO to take these measures;
• requiring the TO to appoint a different person for the position in question who does meet the suitability requirements, to reinforce the sound and proper management and control of the TO;
• imposing additional reporting requirements and increasing solvency monitoring activities; or
• withdrawing or imposing conditions on the business licence, especially in the case of a major breach of suitability requirements, taking into account the impact of the breach or the number of members of the board, senior management or key persons in control functions involved.

5.5.2 The supervisor should impose measures of a preventive and corrective nature in respect of significant owners who do not meet suitability requirements. Examples of such measures include:
• requiring the significant owners to dispose of their interests in the TO within a prescribed period of time;
• the suspension of the exercise of their corresponding voting rights; or
• the nullification or annulment of any votes cast by the significant owners.

5.5.3 There can be circumstances where a board member, a member of the senior management or a key person in control functions is unable to carry out their role and a replacement needs to be appointed on short notice. In jurisdictions where the supervisor approves the post-licensing appointment of board members, senior management or key persons in control functions, it may be appropriate for the supervisor to permit the post to be filled temporarily until the successor’s suitability assessment is affirmed. In such circumstances, a supervisor may require that these temporary replacements meet certain suitability requirements, depending on their position or responsibilities within the TO. However, such assessment should be conducted and concluded in a timely manner.

5.6 The supervisor exchanges information with other authorities inside and outside its jurisdiction where necessary to check the suitability of board members, senior management, key persons in control functions and significant owners of a TO.

5.6.1 Supervisors should use the modes available for supervisory cooperation – in particular, the ability to exchange information relevant to check suitability with domestic or foreign authorities. Having such arrangements in place is important so as not to unduly delay relevant supervisory processes and/or affect the TO’s ability to satisfy composition requirements for the board or make necessary changes to its management team (see TCP 3: Information Sharing and Confidentiality Requirements).

5.6.2 The supervisor may use this information as an additional tool to assess effectively the suitability of, or to obtain information about, a board member, a member of the senior management or a key person in control functions.
5.6.3 If a significant owner that is to be assessed is a legal person or a corporate entity regulated in another jurisdiction, the supervisor should seek confirmation from the relevant authority that the entity is in good standing in that other jurisdiction.

TCP 6: CHANGE OF CONTROL AND PORTFOLIO TRANSFERS
The supervisor assesses and decides on proposals:
• to acquire significant ownership of, or an interest in, a TO or TU that results in a person (legal or natural), directly or indirectly, alone or with an associate, exercising control over the TO or TU; and
• for portfolio transfers.

Introductory Guidance

6.0.1 The supervision of change of control and portfolio transfers supports supervisory objectives – in particular:
  • licensing regimes are not undermined by control being obtained or retained by those who would not get a licence ordinarily; and
  • TUs should continue to be held in corporate or other arrangements that allow them to be effectively supervised.

6.0.2 In some business models of Islamic insurance, including the hybrid entity founded on the wakālah contract for underwriting, the ownership of the risk funds is vested not in the TO but in the takāful participants. Notwithstanding this model of ownership, a change in the direct or indirect control of (or in an ownership or voting stake representing a significant influence over) the TO is relevant to supervisory objectives, as the possession of control or significant influence over the TO provides the possessor with influence over the management of the risk funds. Supervision over transactions changing control or significant influence helps ensure that those gaining control or significant influence undergo appropriate scrutiny. It also helps to ensure that group structures in which TOs are held (and risk funds managed) do not inhibit effective supervision.

6.0.3 The transfer of portfolios of contracts from one TO to another can be a feature of takāful markets. Such transfers can enable a TO to exit a market, or to gain sufficient scale to enter one. The ability to perform such transfers can be important for orderly resolution where a TO is unable to continue in operation. Merger of a run-off portfolio into a larger one can also avoid an undesirable tointine effect. Jurisdictions may therefore have provisions allowing for such transfers, if necessary without the consent of all affected takāful participants. Protecting the interests of those holding contracts proposed to be transferred, as well as those holding contracts that are not proposed to be transferred or that are in a risk pool to which contracts are proposed to be transferred, is of importance to supervisory objectives.

6.0.4 To assist in understanding the content of this TCP, it is emphasised that:
• change of control extends beyond the immediate controlling interest, such as the ownership of equity in a TO, and includes other actions that have the potential to change the exercise of control over the TO;
• change of control is relevant, both at the TO or, where appropriate, TU and intermediate and ultimate beneficial owner levels;
• change of control may take place in a variety of forms, such as mergers, acquisitions or (de)mutualisations;
• control includes the exercise of influence over decisions such as those on strategic, operating, investing and financing policies of a TU. It may also include the power to appoint or remove members, or otherwise influence the composition of, the board or of board committees;
• control may be exercised by a person individually, or acting in concert with associates or others, and directly or indirectly through corporate structures or other mechanisms; and
• significant owners and the transactions that determine or change control may be outside of a jurisdiction, but the impact on the ultimate control of the TU in that jurisdiction means that they remain relevant to effective supervision of control.

6.0.5 Supervisory requirements and practices regarding change of control and portfolio transfers may vary, taking into account the nature, scale and complexity of the transactions and the risk posed to achievement of supervisory objectives. For example, portfolio transfers between retakāful providers/reinsurers, internal restructuring transactions within a group that does not change the ultimate beneficial ownership of the entity, and demutualisation, are different types of transactions. Their nature may warrant different supervisory approaches and/or different levels of intensity of supervision.

6.0.6 There may be transactions where a portfolio transfer or a change of control is cross-border in nature. In such cases, the supervisor should coordinate and exchange information with the relevant supervisors (see TCP 3: Information Sharing and Confidentiality Requirements and TCP 25: Supervisory Cooperation and Coordination).

Change of Control

6.1 Legislation addresses change of control of TOs, including:
• having a definition of control; and
• oversight and enforcement of requirements related to change of control.

6.1.1 The definition of "control" should address, at least:
• holding of a defined number or percentage of issued shares or financial instruments above a designated threshold in a TO or its intermediate or ultimate beneficial owner or the head of the insurance group or head of the financial conglomerate as may be the case; and/or
• having a defined percentage of voting rights attached to shares or financial instruments.

6.1.2 In the case of a TU, the definition of “control” may require greater granularity if takāful participants have voting rights in the undertaking. The supervisor may, in such a case, need to consider separately the question of control of the TO and control of the TU. In deciding whether voting rights of takāful participants have effective capacity to deny another party control, the supervisor takes into account the asymmetry of information between the TO and the takāful participants.

6.1.3 Financial instruments other than shares that should be of interest to the supervisor are those that have the potential to impact the levels of control over a TO, including those that may convert in the future into an interest that leads to a change of control through that conversion.

6.1.4 The definition of a threshold for control is not necessarily the same as the definition that may apply for accounting consolidation or other purposes.

6.2 The supervisor requires the TO to provide notification of a proposed change of control of the TO. The supervisor assesses and decides on proposals for change of control.

Notification

6.2.1 The supervisor should require notification of proposals that would lead to increased (or decreased) control.

6.2.2 The supervisor should establish thresholds for notification. Such thresholds may improve transparency and compliance with related requirements while avoiding immaterial notifications. The supervisor typically establishes lower thresholds (such as between 5% and 10%) for initial notification of acquiring control, and a higher percentage for approval and for increased control also requiring approval.

6.2.3 The supervisor may also be informed by notifications made to other authorities such as corporate law supervisors or under rules for publicly traded companies.

6.2.4 Notifications should be submitted to the supervisor in a reasonable time. Changes that arise because of actions of the TO should be subject to advance notification. Actions of others are usually made “subject to” relevant approvals, and so are not effective until approved.

Assessment

6.2.5 The supervisor should assess both actions that lead to new controlling interests and those that lead to material increases in existing controlling interests. Material increases may arise, for example, when existing significant owners increase their interest, when associates increase their
interest, or when a significant owner acquires a new associate who has a plan to acquire an interest (directly or indirectly) in the TO.

6.2.6 The supervisor should obtain the information necessary to assess the change of control. The supervisor may seek such information from the TO, its significant owners, shareholders or other relevant persons. The information obtained should be proportionate to the complexity of the change of control. Regardless, the supervisor should have sufficient information to understand the impact of the change of control on the TU and be able to identify the ultimate beneficial owner.

6.2.7 The supervisor should ascertain whether legislation, or contractual arrangements, give takāful participants a right of consultation or a veto over changes in ownership of the TO. In performing its assessment of the impact of the change of control, the supervisor should consider whether the takāful participants have been provided with sufficient information to enable them to make an informed judgment. The supervisor may take into consideration the views of the takāful participants, but should form its own decision on the proposed change of control and should be able to deny a change of control even when takāful participants have approved it.

6.2.8 When considering whether to approve a change of control that leads to a new significant owner, the supervisor should verify that the approval would not lead to a control arrangement that would not have been approved as part of the jurisdiction's licensing requirements in similar circumstances (see TCP 4: Licensing).

6.2.9 The supervisor should assess whether a new significant owner is suitable to fulfil its role. A significant owner should possess at least the necessary qualities relating to financial soundness and integrity (see TCP 5: Suitability of Persons).

6.2.10 The supervisor should be able to deny a change of control when, for example, it would be prejudicial to the interests of takāful participants, or the resulting structure would not allow for effective supervision, or the ultimate beneficial owner cannot be identified.

Changes in Legal Form of the Undertaking

6.3 A change in the legal form of an undertaking from one permitted form of Islamic insurance undertaking to another – for example, from a mutual company to a stock company, or vice versa – is subject to the supervisor's approval.

6.3.1 Islamic insurance undertakings in different jurisdictions take a number of legal forms, including the cooperative and mutual models, and the model where mudharabah and wakālah contracts are combined with segregation of funds in one legal entity constituted as a limited liability company. A company may propose to change its legal form – for example, by becoming or ceasing to be a mutual. Developments in national legislation on takāful may require undertakings to change their legal form. Circumstances are
also conceivable where a change in legal form is a necessary part of a recovery or resolution programme for an undertaking in difficulty. Accordingly, legislation should provide a framework for a change in the legal form of TUs, either at their own discretion or if so directed by the supervisor.

6.3.2 The process for change in legal form may vary by jurisdiction. For example, the ultimate approval may be provided by authorities other than the supervisor, such as the courts. Takāful participants may also have the right to vote on a change in legal form as a result of their contracts or the entity’s constitutional documents.

6.3.3 In assessing a change in legal form, the supervisor should consider the impact on the financial condition of the undertaking and the ongoing rights and obligations of the takāful participants, including any entitlements to surplus. The supervisor should also assess whether the new governing organisational document of the company adequately protects current and future takāful participants.

Portfolio Transfer

6.4 The supervisor assesses and decides on the transfer of all or a part of a TO’s business portfolio taking into account at least the financial condition of the transferee and the transferor and whether the interests of the takāful participants of both the transferee and transferor will be protected.

6.4.1 Takāful contracts are, in Sharī‘ah, legal contracts under which the TO manages the funds contributed by the takāful participants, to provide assistance for those participants. As a result, a TO should not be able unilaterally to alter the terms of a contract by merging its operation with that of another TO, by (de)mutualising or otherwise changing its legal form, or by transferring some of its business to another TO.

6.4.2 In order to protect the interests of takāful participants and to safeguard the financial condition of the TUs involved, legislation should address the conditions for a portfolio transfer. Takāful participants’ benefit expectations and existing takāful contract values should not normally be lessened as a result of a portfolio transfer.

6.4.3 The process for a portfolio transfer may vary by jurisdiction. For example, the ultimate approval may be provided by authorities other than the supervisor, such as courts. Regardless, the supervisor should be consulted and should have the right to object to a portfolio transfer.

6.4.4 Legislation or the terms of the takāful contracts may allow takāful participants to participate in the decision-making process on portfolio transfers, by providing consultation rights, consent rights or in some other manner. Where this is the case, the supervisor may take into consideration
the views of the takāful participants but should form its own decision on the proposed portfolio transfer.

6.4.5 Particularly in the context of a segregation of funds model, legislation may require that takāful participants are notified of an intention to carry out a portfolio transfer, even if there is no requirement for consent. Legislation should set out principles for the timing and manner of notification and for takāful participants to have the opportunity to make representations, before the proposed portfolio transfer is approved.

6.4.6 When assessing a transfer, the supervisor should consider the impact on the transferring takāful participants, as well as on those that are not transferring, and those that are current takāful participants of the TU to which the takāful participants are being transferred. This should apply whether the portfolio transfer is considered a part of normal business, a merger or part of a resolution where the TU is no longer viable (see TCP 12: Exit from the Market and Resolution).

6.4.7 When assessing a proposed transfer of a portfolio of takāful contracts, the supervisor should be aware of the possibility that the takāful business models and, potentially, the contractual relationships may differ between transferor and transferee – for example, waqf in the one case and wakālah in the other, or a policy of distribution of surplus in the one case and retention in the other. In such cases, the supervisor should take care that the assessment of the impact on the transferring takāful participants of the two undertakings, those transferring and those not, give consideration to those differences in the business model. The supervisor could consider giving consent to a transfer only where entitlements are preserved in a separate, segregated fund for the transferred contracts.

TCP 7: CORPORATE GOVERNANCE

The supervisor requires TOs to establish and implement a corporate governance framework which provides for sound and prudent management and oversight of the TU’s business and adequately recognises and protects the interests of takāful participants.

Introductory Guidance

7.0.1 The corporate governance framework of a TO:
• promotes the development, implementation and effective oversight of policies that clearly define and support the objectives of the TO;
• defines the roles and responsibilities of persons accountable for the management and oversight of a TO by clarifying who possesses legal duties and powers to act on behalf of the TU and under which circumstances;
sets requirements relating to how decisions and actions are taken, including documentation of significant or material decisions, along with their rationale;

• provides sound remuneration practices which promote the alignment of remuneration policies with the long-term interests of the TO to avoid excessive risk taking;

• provides for communicating with the supervisor, as appropriate, matters relating to the management and oversight of the TU; and

• provides for corrective actions to be taken for non-compliance or weak oversight, controls or management.

7.0.2 In the case of a TU, corporate governance also recognises the existence of stakeholder relationships and business objectives that differ from those typical of conventional insurers. It includes in its objectives the compliance of its operations and contracts with the Sharī’ah. The organisational relationships comprising its corporate governance therefore provide also for organs of governance such as a Sharī’ah board to oversee, under the ultimate authority of the board, Sharī’ah compliance and to manage Sharī’ah non-compliance risk, and for protection of the interests of takāful participants where conflicts arise between these and the interests of the TO, as may occur under models of takāful operation.

7.0.3 The role of the Sharī’ah board (or similar body tasked by the board, the ultimately responsible body, with overseeing Sharī’ah compliance) in the governance structure and the activities of those performing tasks such as Sharī’ah compliance testing and audit are considered at TCP 8: Sharī’ah Governance.

7.0.4 An effective corporate governance framework enables a TO to be flexible and transparent; to be responsive to developments affecting its operations in making timely decisions; and to ensure that powers are not unduly concentrated. The corporate governance framework supports and enhances the ability of the key players responsible for a TO’s corporate governance – that is, the board, senior management and key persons in control functions – to manage the TO’s business soundly and prudently.

7.0.5 The TO should establish a transparent organisational structure that supports the strategic objectives and operations of the TO. The board and senior management should know and understand the structure and the risks that it poses. The ways in which a TO chooses to organise and structure itself can vary depending on a number of factors such as:

• jurisdictional corporate law, which may allow or require different board structures (such as one-tier or two-tier boards);

• organisational structure, such as stock companies, hybrid corporate structures typical of takāful business models in some jurisdictions, mutuals or cooperatives; and

• group, branches or solo legal entity operations.
These considerations can affect how a TO establishes and implements its corporate governance framework and are explained in more detail below. It is important for supervisors to understand these different considerations in order to be able to adequately assess the effectiveness of a TO’s corporate governance framework.

Organisational Structures

7.0.6 The standards on corporate governance are designed with sufficient flexibility to apply to supervision of TUs regardless of any differences in the corporate structures and legal systems.

7.0.7 The term "board" includes its management and oversight roles, regardless of board structure.

Pure Mutuals and Pure Cooperatives

7.0.8 Governance of TOs or TUs formed as pure mutuals or pure cooperatives is different from that of TOs or TUs formed as joint stock companies (i.e. bodies corporate with shareholders). These standards are nevertheless sufficiently flexible to be adapted to mutuals and cooperatives to promote the alignment of actions and interests of the board and senior management with the broader interests of takāful participants. Where there are references to shareholders or stakeholders, they should be generally treated as references to takāful participants in mutuals, unless otherwise indicated.

7.0.9 Takāful undertakings show a number of different corporate forms, although a given jurisdiction may prescribe the adoption of only one or a limited number of these. A corporate model typical in some jurisdictions is a hybrid operation, including a TO in the same business entity, although not necessarily the same legal entity, as the funds that it manages on behalf of the takāful participants (in which its interest is determined by the form of takāful contract used). The shareholders of the legal entity (the TO) control the undertaking. However, although the interests of takāful participants are, in some cases, held within the same legal entity as the TO, the position of the TO in respect of takāful participants’ interests is, under Shari`ah, a fiduciary one. Such entities have to be considered from the perspective of regulatory objectives, both as stock companies and as mutual or cooperative companies, depending on the context.

7.0.10 Legislation, or the constitutional documents of an Islamic insurance undertaking, may provide for representation of the takāful participants on its governing body, or other means of protection of their interests.

7.0.11 In the case of the corporate structure just described, where shareholders’ and takāful participants’ interests are contained within the same business operation, the standards and guidance in this TCP should be applied considering the interests of takāful participants as being those of owners
of the funds attributed collectively to them, and the duties of the TO as including fiduciary responsibility towards those participants.

Islamic Window Operations

7.0.12 Some jurisdictions permit the operation by conventional insurers of a segregated “window”, being a part or division of the insurer conducting operations on a takāful basis. Where this is the case, the supervisor should consider the effectiveness of the corporate governance arrangements applicable to the window, and take into consideration the business model adopted within the window, when necessary, as though the window were a separate legal entity. Further considerations on window operations are set out in TCP 26: Takāful Windows.

Insurance Groups

7.0.13 Insurance groups should ensure that the corporate governance framework is appropriate to the structure, business and risks of the insurance group and its legal entities. The corporate governance framework should include policies, processes and controls which address risks across the insurance group and legal entities, and clear reporting lines between the head of the group and the legal entities within the group.

7.0.14 When setting up or monitoring their corporate governance framework, insurance groups should evaluate the specific challenges which may arise from the organisational model adopted by a group (e.g. more centralised or more decentralised model). The main factors underlying the challenges are:

- the division of authorities and responsibilities between the key players at the insurance group and legal entity level;
- effective group-wide direction and coordination;
- proper consideration of the legal obligations, governance responsibilities and risks both at the insurance group and legal entity level; and
- effective communication within the group and adequate information at all levels (see Issues Paper on Approaches to Group Corporate Governance; Impact on Control Functions).

7.0.15 The supervisor should take the organisational structure of the group into consideration in evaluating its governance. Particularly when the management structure differs from the legal entity structure, it is not sufficient to assess governance only at the legal entity level. In such a case, it is important that appropriate governance exists across the group and that the supervisor assesses it on a group-wide basis.

7.0.16 The group’s structure and organisation can be relevant to the regulatory objectives of the supervisor of a TU that is a member of an insurance group, whether or not the group is confined to Islamic insurance business.
For example, if management decision making relating to a TU appears to reside elsewhere in the group, the supervisor may question whether the corporate governance over the *takaful* operations that it supervises is effective, particularly if the decision making concerned is outside the scope of the TU’s Sharī‘ah governance. Where the supervisor has such concerns, the supervisor should communicate with other relevant supervisors in the group, including, if the group is an IAIG, the group-wide supervisor.

*Branch Operations*

7.0.17 If a TU is a branch, these standards would generally apply to the legal entity in its home jurisdiction. However, the host supervisor may require designated oversight and/or management accountabilities and structures to be maintained at the branch, including, in some cases, a designated representative responsible for the management of the branch. In such cases, these standards should also apply, as appropriate, to the oversight and management roles maintained within the branch, taking due account of the governance structures and arrangements as determined by the host supervisor.

7.1 The supervisor requires the TO’s board to:

- ensure that the roles and responsibilities allocated to the board, Sharī‘ah board, senior management and key persons in control functions are clearly defined so as to promote an appropriate separation of the oversight function from the management responsibilities; and
- provide oversight of the senior management.

*Appropriate Allocation of Oversight and Management Responsibilities*

7.1.1 The board should ensure that the TO has a well-defined governance structure which provides for the effective separation between oversight and management functions. The board is responsible for providing the overall strategy and direction for the TU and for overseeing its proper overall management, while leaving the day-to-day management of the TU to senior management. The separation of the roles of the chair of the board and the chief executive officer (CEO) reinforces a clear distinction between accountability for oversight and management.

7.1.2 The board should also ensure that there is a clear allocation of roles and responsibilities to the board as a whole, to committees of the board where they exist, and to the senior management and key persons in control functions to ensure proper oversight and sound management of the TO. The allocation of roles and responsibilities should clearly identify the individual and collective accountabilities for the discharge of the respective roles and responsibilities. The organisational structure of the TO and the assignment of responsibilities should enable the board and senior management to carry out their roles in an adequate and objective manner and should facilitate effective decision making.
7.1.3 The allocation of responsibilities to individual board members (e.g. the membership of board committees such as the audit or remuneration committee) should take due account of whether the relevant member has the degree of independence and objectivity required to carry out the functions of the particular committee. The effective oversight of the executive functions should be performed by the non-executive members of the board, because they are not involved in the day-to-day management of the TU. Within a group the allocation and division of the oversight and management responsibilities at different levels should be transparent, appropriate for and aligned with the organisational model of the group. Where individuals undertake functions for more than one legal entity within a group, the group should have in place appropriate measures so that conflicts of interest between the different roles to be performed by such individuals are avoided; or where such conflicts cannot be avoided, they should be managed.

7.1.4 In order to provide effective oversight of the senior management, the board should:

- ensure that there are adequate policies and processes relating to the appointment, dismissal and succession of the senior management, and be actively involved in such processes;
- ensure that senior management’s knowledge and expertise remain appropriate given the nature of the business and the TU’s risk profile;
- monitor whether the senior management is managing the affairs of the TU in accordance with the strategies and policies set by the board, and the TU’s risk appetite, corporate values and corporate culture;
- set appropriate performance and remuneration standards for senior management consistent with the long-term strategy and the financial soundness of the TU and monitor whether the senior management is meeting the performance goals set by the board;
- regularly meet with the senior management to discuss and review critically the decisions made, information provided and any explanations given by the senior management relating to the business and operations of the TU; and
- have regular interaction with any committee it establishes as well as with other key functions, proactively request information from them and challenge that information when necessary.

7.1.5 As a part of its regular monitoring and review of the TU’s operations, the board should review whether the relevant policies and processes, as set by the board, are being properly implemented by senior management and are operating as intended. Particular attention should be paid as to whether the responsibilities for managing and implementing the policies of the board have been effectively discharged by those responsible. The board should obtain reports at least annually for this purpose and such reports may include internal or external independent reports as appropriate.
7.1.6 TCP 8: *Sharī`ah Governance* provides information on the responsibilities of the Sharī`ah board or other body tasked with ensuring Sharī`ah compliance of a TU’s operations and contracts. The supervisor requires the board to monitor the operation of the TO’s Sharī`ah governance system as part of its responsibility to undertake regular monitoring and review of the TU’s operations.

**Corporate Culture, Business Objectives and Strategies of the TO**

7.2 The supervisor requires the TO’s board to set and oversee the implementation of the TO’s corporate culture, business objectives and strategies for achieving those objectives, in line with the TU’s long-term interests and viability.

7.2.1 The board should adopt a rigorous process for setting, approving and overseeing the implementation of the TO’s overall business objectives and strategies, taking into account the long-term financial safety and soundness of the TU as a whole, the interests of its *takāful* participants and other stakeholders, and the fair treatment of customers. The board ensures that the senior management has adequately documented and communicated these objectives and strategies to the key persons in control functions and all other relevant staff.

7.2.2 The business objectives and strategies of a TU necessarily include the maintenance of Sharī`ah compliance and protection of the interests of *takāful* participants in the fund to which they contribute and from which their compensation is paid.

7.2.3 The effective implementation of objectives and strategies should be supported by the corporate culture and by clear and objective performance goals and measures, taking due account of, among other things, the TO’s long-term interests and viability and the interests of *takāful* participants and other stakeholders. The board should review the appropriateness of the goals and measures set.

7.2.4 A corporate culture reflects the fundamental corporate values and includes norms for responsible and ethical behaviour applicable to all employees of the TO. The board should take the lead in setting the appropriate tone at the top. This includes adherence to the corporate values by the board and a strong risk culture avoiding excessive risk taking. The corporate values, norms and supporting policies should be communicated throughout the TU. These are also reflected in the TO’s business objectives and strategies, and supported by professional standards and codes of ethics that set out what the TO considers to be acceptable and unacceptable conduct. In this regard, the board should take account of the interests of *takāful* participants and other relevant stakeholders. In setting the tone at the top, the board should ensure that employees are aware that appropriate disciplinary or other actions will follow unacceptable behaviours.
The promotion of accountability, integrity and transparency is a desirable aspect of corporate culture in both takāful and conventional insurance. In takāful, the means of achieving ethical outcomes, as well as the outcomes themselves, are required to comply with Sharī‘ah principles.

The board should ensure that the corporate culture promotes timely and frank discussion and escalation of problems to senior management or itself. The board should set and oversee the implementation of transparent policies and processes which promote and facilitate that employees can communicate concerns or information about illegal or unethical behaviour confidentially, and without reprisal, directly or indirectly to the board (e.g. whistle-blower policy). The board should determine how and by whom legitimate concerns shall be investigated and addressed (senior management, board or an external party).

The board should define and oversee the implementation of norms for responsible and ethical behaviour. It should not allow behaviour that would be incompatible with the protection of takāful participants and that could lead to reputational risks or improper or illegal activity, such as financial misreporting, fraud, money laundering, bribery and corruption. The norms for responsible and ethical behaviour should also make clear that employees are expected to conduct themselves ethically in addition to complying with laws, regulations and the TU’s policies.

Where the segregation of funds is practised, the board should ensure that the basis of compensation of the TO (for managing the takāful funds) is consistent with the basis disclosed to takāful participants. The board should also ensure that the attribution of expenses and income of the operation between the segregated funds has due regard to fairness in terms of the interests of takāful participants as owner under Sharī‘ah of the takāful funds and the interests of the TO as manager. The TO should not charge expenses to the takāful fund, which has already paid a fee for the TO to bear.

The board should ensure that the TO’s corporate governance framework and overall business objectives and strategies are reviewed at least annually to ensure that they have been properly implemented and that they remain appropriate in light of any material changes in the organisational structure, activities, strategy, and regulatory and other external factors. The board should ensure more frequent reviews – for instance, when a TO embarks on a significant new business initiative (e.g. a merger or acquisition, or a material change in the direction with respect to the TU’s product portfolio, risk or marketing strategies), upon the introduction of a new type or class of risk or product, or a decision to market products to a new class or category of clients, or following the occurrence of significant external or internal events which may potentially have a material impact on the TU (including its financial condition, objectives and strategies) or the interests of its takāful participants or other stakeholders.
Structure and Governance of the Board

7.3 The supervisor requires the TO’s board to have, on an ongoing basis:

- an appropriate number and mix of individuals to ensure that there is an overall adequate level of competence at the board level commensurate with the governance structure;
- appropriate internal governance practices and procedures to support the work of the board in a manner that promotes the efficient, objective and independent judgment and decision making by the board; and
- adequate powers and resources to be able to discharge its duties fully and effectively.

Board Composition

7.3.1 The board of a TO should have a sufficient number of members who have relevant expertise among them as necessary to provide effective leadership, direction and oversight of the TO’s business to ensure it is conducted in a sound and prudent manner. For this purpose, the board should collectively and individually have, and continue to maintain, including through training, the necessary skills, knowledge and understanding of the TO’s business to be able to fulfil their roles. In particular, the board should have, or have access to, knowledge and understanding of areas such as the lines of takāful underwritten by the TU, actuarial and underwriting risks, finance, accounting, the role of control functions, investment analysis and portfolio management, and obligations relating to fair treatment of customers. While certain areas of expertise may lie in some, but not all, members, the collective board should have an adequate spread and level of relevant competencies and understanding as appropriate to the takāful’s business.

7.3.2 Board members should have the commitment necessary to fulfil their roles, demonstrated by, for example, a sufficient allocation of time to the affairs of the TO and reasonable limits on the number of board memberships held within or outside the insurance group.

Board Effectiveness

7.3.3 The board should review, at least annually, its own performance to ascertain whether members collectively and individually remain effective in discharging the respective roles and responsibilities assigned to them and identify opportunities to improve the performance of the board as a whole. The board should implement appropriate measures to address any identified inadequacies, including any training programmes for board members. The board may also consider the use of external expertise from time to time to undertake its performance assessment where appropriate in order to enhance the objectivity and integrity of that assessment process.

Internal Governance
7.3.4 The board should have appropriate practices and procedures for its own internal governance, and ensure that these are followed and periodically reviewed to assess their effectiveness and adequacy. These may be included in organisational rules or by-laws, and should set out how the board will carry out its roles and responsibilities. They should also cover a formal and documented process for nomination, selection and removal of board members, and a specified term of office as appropriate to the roles and responsibilities of the board member, particularly to ensure the objectivity of decision making and judgment. Appropriate succession planning should also form part of the board’s internal governance practices.

Chair of the Board

7.3.5 While the board as a whole remains collectively responsible for the stewardship of the TO, the chair of the board has the pivotal role of providing leadership to the board for its proper and effective functioning. The role of the chair of the board should generally encompass responsibilities such as setting the board’s agenda, ensuring that there is adequate time allocated for the discussion of agenda items, especially if they involve strategic or policy decisions of significant importance, and promoting a culture of openness and debate by facilitating effective participation of non-executive and executive members and communication between them and also with the senior management and key persons in control functions. To promote checks and balances, it is good practice for the chair of the board to be a non-executive board member and not serve as chair of any board committee. In jurisdictions where the chair of the board is permitted to assume executive duties, the TO should have measures in place to mitigate any adverse impact on the TO’s checks and balances.

Board Committees

7.3.6 To support the effective discharge of the responsibilities of the board, the board should assess whether the establishment of committees of the board is appropriate. Committees that a board may commonly establish include audit, remuneration, ethics/compliance, nominations and risk management committees. Where committees are appointed, they should have clearly defined mandates and working procedures (including reporting to the board), authority to carry out their respective functions, and a degree of independence and objectivity as appropriate to the role of the committee. The board should consider occasional rotation of members and of the chairs of committees, or tenure limits to serve on a committee, as this can help to avoid undue concentration of power and promote fresh perspectives. If the functions of any committees are combined, the board should ensure such a combination does not compromise the integrity and/or effectiveness of the functions combined. In all cases, the board remains ultimately responsible for matters delegated to any such committees.
Independence and Objectivity

7.3.7 To promote objectivity in decision making by the board, the formal and perceived independence of board members should be ensured. To that end, board members should avoid personal ties or financial or business interests which conflict with that of the TO. Where it is not reasonably possible to avoid conflicts of interests, such conflicts should be managed. Documented procedures and policies should be in place to identify and address conflicts of interests which could include disclosure of potential conflicts of interests, requirements for arm's-length transactions, abstention of voting and, where appropriate, prior approval by the board or shareholders of professional positions or transactions.

7.3.8 When assessing their independence, board members in TUs that operate the hybrid business model should consider the possibility that they have interests which, although aligned with the TO, conflict with those of takāful participants, given the fiduciary nature of the relationship between the TO and those participants. For example, a board member (or other member of senior management) may be able to influence the choice of recipient of zakāh or of charitable disbursements paid from TU funds. Such ability to influence should not be used improperly.

7.3.9 Besides policies on conflicts of interests, the TO should ensure objectivity in decision making by establishing clear and objective independence criteria which should be met by an adequate number of members of the board (i.e. non-executive board members). For this purpose, the independence criteria should also take account of group structures and other applicable factors. Meeting such criteria is particularly important for those board members undertaking specific roles (such as members of the remuneration and audit committees) in which conflicts of interests are more likely to arise.

7.3.10 Objectivity in decision making is also promoted by independence of mind of the individual board members. This means that a board member should act without favour; provide constructive and robust challenge of proposals and decisions; ask for information when the member judges it necessary in the light of the issues; and avoid “group-think”.

7.3.11 Board members should also bear in mind the duties of good faith and loyalty applicable to them at the individual level, as set out in Standard 7.4.

Board Powers

7.3.12 To be able to discharge its role and responsibilities properly, the board should have well-defined powers that are clearly set out either in legislation and/or as part of the constituent documents of the TU (such as the constitution, articles of incorporation, by-laws or internal/organisational rules). These should, at least, include the power to obtain timely and
comprehensive information relating to the management of the TO, including direct access to relevant persons within the organisation for obtaining information, such as senior management and key persons in control functions.

7.3.13 The relationship between the board and the Sharī`ah board should be set out in the company’s constituent document, if it is not set out in legislation. The description should cover the obligation of the board to consult the Sharī`ah board on relevant matters, and the right of the Sharī`ah board to have access to the board. Further details on Sharī`ah governance are provided at TCP 8: Shari`ah Governance.

Access to Resources

7.3.14 Adequate resources, such as sufficient funding, staff and facilities, should be allocated to the board to enable the board members to carry out their respective roles and responsibilities efficiently and effectively. The board should have access to services of external consultants or specialists where necessary or appropriate, subject to criteria (such as independence) and due procedures for appointment and dismissal of such consultants or specialists.

Delegations

7.3.15 The board may delegate some of the activities or tasks associated with its own roles and responsibilities. (Delegations in this context are distinguished from outsourcing of business activities by the TO, which is dealt with in TCP 9: Risk Management and Internal Controls.) Notwithstanding such delegations, the board as a whole retains the ultimate responsibility for the activities or tasks delegated, and for the decisions made in reliance on any advice or recommendations made by the persons or committees to whom the tasks were delegated.

7.3.16 Where the board makes any delegations, it should ensure that:

- the delegation is appropriate. Any delegation that results in the board not being able to discharge its own roles and responsibilities effectively would be an undue or inappropriate delegation. For example, the duty to oversee the senior management should not be delegated to a board committee comprised mostly or solely of executive members of the board who are involved in the day-to-day management of the TO;
- the delegation is made under a clear mandate with well-defined terms such as those relating to the powers, accountabilities and procedures relating to the delegation, and is supported by adequate resources to effectively carry out the delegated functions;
- there is no undue concentration of powers giving any one person or group of individuals an unfettered and inappropriate level of powers capable of influencing the TO’s business or management decisions;
- it has the ability to monitor and require reports on whether the delegated tasks are properly carried out; and
• it retains the ability to withdraw the delegation if it is not discharged properly and for due purposes by the delegate, and, for this purpose, to have appropriate contingency arrangements in place.

Duties of Individual Board Members

7.4 The supervisor requires that an individual member of the board:
• act in good faith, honestly and reasonably;
• exercise due care and diligence;
• act in the best interests of the TU and takāful participants, putting those interests ahead of their own interests;
• exercise independent judgment and objectivity in their decision making, taking due account of the interests of the TU and takāful participants; and
• not use their position to gain undue personal advantage or cause any detriment to the TU.

7.4.1 The specific duties identified above are designed to address conflicts of interests that arise between the interests of the individual members of the board and those of the TO and takāful participants. The TO should include these duties as part of the terms of engagement of the individual board members.

7.4.2 The supervisor should be satisfied that individual board members understand the nature and scope of their duties and how they impact on the way in which the member discharges their respective roles and responsibilities. A board member should consider their ability to discharge the roles and responsibilities in a manner as would be expected of a reasonably prudent person placed in a similar position. They should act on a fully informed basis, and for this purpose continually seek and acquire information as necessary.

7.4.3 Where a member of the board of a TO has common membership on the board of any other entity within or outside the TU’s group, there should be clear and well-defined procedures regarding the member’s duty of loyalty to the TO. These may include appropriate disclosure and, in some instances, shareholder approval of such overlapping roles. In the event of a material conflict with the interests of the TU, the member should disclose such conflicts promptly to the board of the TO and its stakeholders as appropriate, and be required to decline to vote or take any decisions in any matters in which they have an interest.

Duties Related to Risk Management and Internal Controls

7.5 The supervisor requires the TO’s board to provide oversight in respect of the design and implementation of risk management and internal controls.

7.5.1 It is the board’s responsibility to ensure that the TO has appropriate systems and functions for risk management and internal controls and to
provide oversight to ensure that these systems and the functions that oversee them are operating effectively and as intended. The responsibilities of the board are described further in TCP 9: Risk Management and Internal Controls.

Duties Related to Remuneration

7.6 The supervisor requires the TO’s board to:

- adopt and oversee the effective implementation of a written remuneration policy for the TO, which does not induce excessive or inappropriate risk taking, is in line with the corporate culture, objectives, strategies, identified risk appetite and long-term interests of the TU, and has proper regard to the interests of its takāful participants and other stakeholders; and
- ensure that such a remuneration policy, at least, covers those individuals who are members of the board, senior management, key persons in control functions and other employees whose actions may have a material impact on the risk exposure of the TU (major risk-taking staff).

7.6.1 Sound remuneration policy and practices are part of the corporate governance framework of a TO. This standard and guidance are neither intended to unduly restrict nor reduce a TO’s ability to attract and retain skilled talent by prescribing any particular form or level of individual remuneration. Rather, they aim to promote the alignment of remuneration policies with the long-term interests of TUs to avoid excessive risk taking, thereby promoting sound overall governance of TUs and fair treatment of customers.

Overall Remuneration Strategy and Oversight

7.6.2 As a part of effective risk management, a TO should adopt and implement a prudent and effective remuneration policy. Such a policy should not encourage individuals, particularly members of the board and senior management, key persons in control functions and major risk-taking staff, to take inappropriate or excessive risks, especially where performance-based variable remuneration is used.

7.6.3 The board, particularly members of the remuneration committee where one exists, should collectively have the requisite competencies to make informed and independent judgments on the suitability of a TO’s remuneration policy. Such competencies include skills, such as a sufficient understanding of the relationship between risk and remuneration practices. The remuneration committee, where established, should have an adequate representation of non-executive members to promote objectivity in decision making.

7.6.4 In order to satisfy itself about the effectiveness of the remuneration policy and practices, the board should consider at least:

- the components of the overall remuneration policy, particularly the use and balance of fixed and variable components;
- the performance criteria and their application for the purposes of determining remuneration payments;
- the remuneration of the members of the board, senior management and major risk-taking staff; and
- any reports or disclosures on the TO’s remuneration practices provided to the supervisor or the public.

7.6.5 The board should ensure that in structuring, implementing and reviewing the TO’s remuneration policy, the decision-making process identifies and manages conflicts of interests and is properly documented. Members of the board should not be placed in a position of actual or perceived conflicts of interests in respect of remuneration decisions.

7.6.6 The board should also ensure that the relevant key persons in control functions are involved in the remuneration policy-setting and monitoring process to ensure that remuneration practices do not create incentives for excessive or inappropriate risk taking, are carried out consistently with established policies, and promote alignment of risks and rewards across the organisation. Similarly, the remuneration and risk management committees of the board, if such committees exist, should interact closely with each other and provide input to the board on the incentives created by the remuneration system and their effect on risk-taking behaviour.

7.6.7 The potential for conflicts of interests that may compromise the integrity and objectivity of the staff involved in control functions should be managed. This can be achieved by a variety of means, such as making their remuneration:
- predominantly based on the effective achievement of the objectives appropriate to such control functions. Performance measures for staff in control functions should represent the right balance between objective assessments of the control environment (e.g. the conduct of the relationship between the control functions and executive management) and outputs delivered by the control functions, including their impact, quality and efficiency in supporting the oversight of risks. Such output measures may include recommendations made and implemented to reduce risks, reduction in number of compliance breaches and measures adopted to promptly rectify identified breaches, results of external quality reviews, and losses recovered or avoided through audits of high-risk areas;
- not linked to the performance of any business units which are subject to their control or oversight. For example, where risk and compliance functions are embedded in a business unit, a clear distinction should be drawn between the remuneration policy applicable to staff undertaking control functions and other staff in the business unit, such as through the separation of the pools from which remuneration is paid to the two groups of staff; and
- adequate as an overall package to attract and retain staff with the requisite skills, knowledge and expertise to discharge those control functions effectively and to increase their competence and performance.
7.6.8 Where any control function is outsourced, the remuneration terms under the agreement with the service provider should be consistent with the objectives and approved parameters of the TO’s remuneration policy.

Variable Remuneration

7.6.9 Variable remuneration should be performance-based using measures of individual, unit or group performance that do not create incentives for inappropriate risk taking.

7.6.10 In TUs, and in particular in TUs that operate the hybrid business model, the nature of the relationship between the TO and the takāful participants means that the board needs to be aware of the risk of conflicting incentives when setting remuneration policies, as the interests of the TO and of the takāful participants may conflict.

7.6.11 To better align performance-based incentives with the long-term value creation and the time horizon of risks to which the TU may be exposed, due consideration should be given to the following:

- There should be an appropriate mix of fixed and variable components, with adequate parameters set for allocating cash versus other forms of remuneration, such as shares. A variable component linked to performance that is too high relative to the fixed component may make it difficult for a TO to reduce or eliminate variable remuneration in a poor financial year.
- The reward for performance should include an adjustment for the material current and future risks associated with performance. Since the time horizon of performance and associated risks can vary, the measurement of performance should, where practicable, be set in a multi-year framework to ensure that the measurement process is based on longer-term performance.
- If the variable component of remuneration is significant, the major part of it should be deferred for an appropriate specified period. The deferral period should take account of the time frame within which risks associated with the relevant performance (such as the cost of capital required to support risks taken and associated uncertainties in the timing and the likelihood of future revenues and expenses) may materialise. The deferral period applied may vary depending on the level of seniority or responsibility of the relevant individuals and the nature of risks to which the TU is exposed.
- The award of variable remuneration should contain provisions that enable the TO, under certain circumstances, to apply malus or claw-back arrangements in the case of subdued or negative financial performance of the TO which is attributed to the excessive risk taking of the staff concerned and when risks of such performance have manifested after the award of variable remuneration.
• Guaranteed variable remuneration should generally not be offered, as this is not consistent with sound risk management and performance-based rewards.

7.6.12 The variable component should be subject to prudent limits set under the remuneration policy that are consistent with the TU’s capital management strategy and its ability to maintain a sound capital base taking account of the internal capital targets or regulatory capital requirements of the TU.

7.6.13 The performance criteria applicable to the variable components of remuneration should promote a complete assessment of risk-adjusted performance. For this purpose, due consideration should be given to the need for performance criteria to:
• be clearly defined and be objectively measurable;
• be based not only on financial but also on non-financial criteria as appropriate (such as compliance with regulation and internal rules, achievement of risk management goals, adequate and timely follow-up of internal audit recommendations, as well as compliance with market conduct standards and fair treatment of customers);
• take account not only of the individual’s performance, but also of the performance of the business unit concerned where relevant and the overall results of the TU and the group; and
• not treat growth or volume as a criterion in isolation from other performance criteria.

7.6.14 In setting performance criteria for remuneration of staff, the board of a TO operating the hybrid business model should be aware of the risk that criteria are affected inappropriately by the way in which the TO itself is remunerated for managing takāful funds attributable to takāful participants and the attribution of expenses between the TO’s own funds and the takāful funds, which may vary according to local practice and local law.

Share-Based Components

7.6.15 Where share-based components of variable remuneration (such as shares, share options or similar instruments) are used, appropriate safeguards should be implemented to align incentives and the longer-term interests of the TU. Such safeguards may include that:
• shares do not vest for a minimum specified period after their award (“vesting restrictions”);
• share options or other similar rights are not exercisable for a minimum specified period after their award (“holding restrictions”); and
• individuals are required to retain an appropriate proportion of the shares awarded until the end of their employment or other specified period beyond their employment (“retention restrictions”).

7.6.16 Subject to any applicable legal restrictions, it is appropriate that future vesting and holding restrictions for share-based remuneration remain operative even upon cessation of employment (i.e. there should be no
undue acceleration of the vesting of share-based payments or curtailing of any holding restrictions).

**Severance Payments**

7.6.17 Where a TO provides discretionary pay-outs on termination of employment ("severance payments", sometimes also referred to as “golden parachutes”), such payment should be subject to appropriate governance controls and limits. In any case, such pay-outs should be aligned with the TU's overall financial condition and performance over an appropriate time horizon. Severance payments should be related to performance over time, should not reward failure, and should not be payable in the case of failure or threatened failure of the TU, particularly to an individual whose actions have contributed to the failure or potential failure of the TU.

**Reliable and Transparent Financial Reporting**

7.7 The supervisor requires the TO’s board to ensure there is a reliable financial reporting process for both public and supervisory purposes that is supported by clearly defined roles and responsibilities of the board, senior management and the external auditor.

7.7.1 The board is responsible for overseeing the TO’s systems and controls to ensure that the financial reports of the TU present a balanced and accurate assessment of the TU’s business and its general financial condition and viability. The board carries out functions including:

- overseeing the financial statements, financial reporting and disclosure processes;
- monitoring whether accounting policies and practices of the TO are operating as intended;
- overseeing the internal audit process (reviews by internal audit of the TO’s financial reporting controls) and reviewing the internal auditor’s plans and material findings; and
- reporting to the supervisor on significant issues concerning the financial reporting process, including actions taken to address or mitigate identified financial reporting risks.

7.7.2 The board should ensure that significant findings and observations regarding weaknesses in the financial reporting process are promptly rectified. This should be supported by a formal process for reviewing and monitoring the implementation of recommendations by the external auditor.

**External Audit**

7.8 The supervisor requires the TO’s board to ensure that there is adequate governance and oversight of the external audit process.
7.8.1 The board should ensure that the TO:
- applies robust processes for approving, or recommending for approval, the appointment, reappointment, removal and remuneration of the external auditor;
- applies robust processes for monitoring and assessing the independence of the external auditor and to ensure that the appointed external auditor has the necessary knowledge, skills, expertise, integrity and resources to conduct the audit and meet any additional regulatory requirements;
- monitors and assesses the effectiveness of the external audit process throughout the audit cycle;
- investigates circumstances relating to the resignation or removal of an external auditor, and ensuring prompt actions are taken to mitigate any identified risks to the integrity of the financial reporting process; and
- reports to the supervisor on circumstances relating to the resignation or removal of the external auditor.

7.8.2 The board should oversee the external audit process and safeguard and promote an effective relationship with the external auditor. For this purpose, the board should ensure that:
- the terms of engagement of the external auditor are clear and appropriate to the scope of the audit and resources required to conduct the audit and specify the level of audit fees to be paid;
- the auditor undertakes a specific responsibility under the terms of engagement to perform the audit in accordance with relevant local and international audit standards;
- the external auditor complies with internationally accepted ethical and professional standards and, where applicable, the more stringent requirements applicable to audits of listed entities and public interest entities;
- there are adequate policies and a process to ensure the independence of the external auditor, including:
  - restrictions and conditions for the provision of non-audit services which are subject to approval by the board;
  - periodic rotation of members of the audit team and/or audit firm as appropriate; and
  - safeguards to eliminate or reduce to an acceptable level identified threats to the independence of the external auditor;
- there is adequate dialogue with the external auditor on the scope and timing of the audit to understand the issues of risk, information on the TO's operating environment which is relevant to the audit, and any areas in which the board may request for specific procedures to be carried out by the external auditor, whether as a part or an extension of the audit engagement; and
- there is unrestricted access by the external auditor to information and persons within the TO as necessary to conduct the audit.

7.8.3 In order to establish the degree of assurance that the board can draw from the external auditor’s report, the board should also understand the external
The auditor’s approach to the audit. This includes the assessment of the external auditor’s ability to:

- identify and assess the risks of material misstatement in the TO’s financial statements, taking into consideration the complexities of takāful activities and the need for TOs to have a strong control environment;
- respond appropriately to the risks of material misstatement in the TO’s financial statements; and
- develop appropriate relationships with the internal audit function and the actuarial function.

The board should take appropriate actions where doubts arise as to the reliability of the external audit process.

7.8.4 In order to enable the board to carry out its oversight responsibilities and to enhance the quality of the audit, the board should have an effective communication with the external auditor. This should include:

- regular meetings between the board and the external auditor during the audit cycle, including meetings without management present; and
- prompt communication of any information regarding internal control weaknesses or deficiencies of which the external auditor becomes aware.

The board should require the external auditor to report to it on all relevant matters.

7.8.5 The supervisor and the external auditor should have an effective relationship that includes appropriate communication channels for the exchange of information relevant to carrying out their respective statutory responsibilities.

7.8.6 Reports prepared by the external auditor for the TO (e.g. management letters) should be made available to the supervisor by the TO or the external auditor.

7.8.7 The supervisor should require the external auditor to report matters that are likely to be of material significance. This would include material fraud, suspicion of material fraud and regulatory breaches or other significant audit findings identified in the course of the audit. Such information should be provided to the supervisor without the need for prior consent of the TO and the external auditor should be duly protected from liability for any information disclosed to the supervisor in good faith.

7.8.8 The supervisor should require a further audit by a different external auditor where necessary.

Communications
7.9 The supervisor requires the TO's board to have systems and controls to ensure appropriate, timely and effective communications with the supervisor on the governance of the TO.

7.9.1 Communications with the supervisor should promote effective engagement of the supervisor on the governance of the TO to enable informed judgments about the effectiveness of the board and senior management in governing the TO.

7.9.2 Subject to any reasonable commercial sensitivities and applicable privacy or confidentiality obligations, the TO's communication policies and strategies should include providing to the TU's stakeholders information such as the following:

- the TO's overall strategic objectives, covering existing or prospective lines of business and how they are being or will be achieved;
- the TO's governance structures, such as allocation of oversight and management responsibilities between the board and the senior management, and organisational structures, including reporting lines;
- members of the board and any board committees, including their respective expertise, qualifications, track record, other positions held by such members, and whether such members are regarded as independent;
- processes in place for the board to evaluate its own performance and any measures taken to improve the board's performance;
- the general design, implementation and operation of the remuneration policy;
- major ownership and group structures, and any significant affiliations and alliances; and
- material related-party transactions.

7.9.3 In addition to information publicly available, the supervisor may require more detailed and additional information relating to the TO's corporate governance framework for supervisory purposes, which may include commercially sensitive information, such as assessments by the board of the effectiveness of the TO's governance system, internal audit reports and more detailed information on the remuneration structures adopted by the TO for the board, senior management, key persons in control functions and major risk-taking staff. The TO's communication policies and strategies should enable such information to be provided to the supervisor in a timely and efficient manner. Supervisors should safeguard such information having due regard to the confidentiality of commercially sensitive information and applicable laws.

7.9.4 Disclosure of information on remuneration should be sufficient to enable stakeholders to evaluate how the remuneration system relates to risk and whether it is operating as intended. Relevant information may include:
• the operation of risk adjustments, including examples of how the policy results in adjustments to remuneration for employees at different levels;
• how remuneration is related to performance (both financial and personal business conduct) over time; and
• valuation principles in respect of remuneration instruments.

7.9.5 Appropriate quantitative information should also be made available to enable supervisors to evaluate the financial impact of the remuneration policy. Such information may include:
• the total cost of remuneration awarded in the period, analysed according to the main components such as basic salary, variable remuneration and long-term awards;
• the total amount set aside in respect of deferred variable remuneration;
• adjustment to net income for the period in respect of variable remuneration awarded in previous periods;
• the total costs of all sign-on payments in the period and number of individuals to whom these relate; and
• the total costs of all severance payments in the period and number of individuals to whom these relate.

7.9.6 These amounts should be analysed by type of instrument (e.g. cash, shares, share options, etc.) as applicable, and in a manner consistent with the key elements of the remuneration policy.

7.9.7 TUs that operate the hybrid business model should also provide the supervisor with qualitative and quantitative information on the basis of fees receivable by the TO from the takāful funds attributable to the takāful participants, and on how income and expenses of the undertaking are allocated between the funds attributable to the TO and the funds attributable to takāful participants.

7.9.8 Disclosure of information on governance should be made on a regular (e.g. at least annually) and timely basis.

Duties of Senior Management

7.10 The supervisor requires the TO to ensure that senior management:
• carries out the day-to-day operations of the TU effectively and in accordance with the TO's corporate culture, business objectives and strategies for achieving those objectives in line with the TU’s long-term interests and viability;
• promotes sound risk management, compliance and fair treatment of customers;
• provides the board adequate and timely information to enable the board to carry out its duties and functions, including the monitoring and review of the performance and risk exposures of the TU, and the performance of senior management; and
maintains adequate and orderly records of the internal organisation.

7.10.1 Senior management should implement appropriate systems and controls, in accordance with the established risk appetite and corporate values and consistent with internal policies and processes.

7.10.2 Such systems and controls should provide for organisation and decision making in a clear and transparent manner that promotes effective management of the TU. Senior management’s systems and controls should encompass:

- processes for engaging persons with appropriate competencies and integrity to discharge the functions under senior management, which include succession planning, ongoing training and procedures for termination;
- clear lines of accountability and channels of communication between persons in senior management and key persons in control functions;
- proper procedures for the delegation of senior management functions and monitoring whether delegated functions are carried out effectively and properly, in accordance with the same principles that apply to delegations by the board (see Guidance paragraphs 7.3.15 and 7.3.16);
- standards of conduct and codes of ethics for senior management and other staff to promote a sound corporate culture, and the effective implementation on an ongoing basis of standards and codes (see TCP 9: Risk Management and Internal Controls for conflicts of interest provisions);
- proper channels of communication, including clear lines of reporting, as between the individuals performing the functions of the senior management and the board, including provisions dealing with whistle-blower protection, and their effective implementation; and
- effective communication strategies with supervisors and stakeholders that include the identification of matters that should be disclosed, and to whom such disclosure should be made.

7.10.3 Adequate procedures should be in place for assessing the effectiveness of senior management’s performance against the performance objectives set by the board. For this purpose, annual assessments of their performance against set goals should be carried out at least annually, preferably by an independent party, a control function or the board itself. Any identified inadequacies or gaps should be addressed promptly and be reported to the board.

7.10.4 Senior management should also promote strong risk management and internal controls through personal conduct and transparent policies. Senior management should communicate throughout the TO the responsibility of all employees in this respect. It should not interfere with the activities that control functions carry out in the rightful exercise of their responsibilities, including that of providing an independent view of governance, risk, compliance and control-related matters.
Supervisory Review

7.11 The supervisor requires the TO to demonstrate the adequacy and effectiveness of its corporate governance framework.

7.11.1 The supervisor plays an important role by requiring the board and senior management of the TO to demonstrate that they are meeting the applicable corporate governance requirements, consistent with these standards, on an ongoing basis. The onus for demonstrating, to the satisfaction of the supervisor, that the corporate governance framework is effective and operates as intended rests with the TO.

7.11.2 The supervisor should assess through its supervisory review and reporting processes whether the TO’s overall corporate governance framework is effectively implemented and remains adequate (see TCP 10: Supervisory Review and Reporting).

7.11.3 To help facilitate the supervisory review and reporting processes, the supervisor should establish effective channels of communication with the TO, and have access to relevant information concerning the governance of the TU. This may be obtained through periodic reports to the supervisor and any information obtained on an ad hoc basis (see also Standard 7.7). Communication may also be facilitated by the supervisor having regular interaction with the board, senior management and key persons in control functions.

7.11.4 The supervisor should assess the governance effectiveness of the board and senior management and determine the extent to which their actions and behaviours contribute to good governance. This includes the extent to which the board and senior management contribute to setting and following the “tone at the top”; how the corporate culture of the TO is communicated and put into practice; how information flows to and from the board and senior management; and how potential material problems are identified and addressed throughout the TU.

7.11.5 To ascertain the ongoing effectiveness of the board and senior management, the supervisor may also consider the use of measures such as the following, where appropriate:

- ongoing mandatory training that is commensurate with the respective duties, roles and responsibilities of the board and senior management within the TO;
- a review of the periodic self-evaluation undertaken by the board as referred to in Guidance paragraphs 7.3.3 and 7.11.1;
- meetings and/or interviews with the board and senior management, both collectively and individually as appropriate, particularly to reinforce expectations relating to their performance and to get a sense of how informed and proactive they are; and
- attending and observing board proceedings.
7.11.6 Where remuneration policies of a TO contain more high-risk elements, closer supervisory scrutiny of those policies and practices may also be warranted, including requests for additional information as appropriate to assess whether those practices are having an adverse impact on the ongoing viability of the TO, or commissioning an independent assessment of the TO’s remuneration policy and practices.

TCP 8: SHARI`AH GOVERNANCE
The supervisor requires a TO to establish and implement a Shari`ah governance framework which provides for effective oversight of Shari`ah compliance within the TU by persons with appropriate levels of knowledge, experience and operational independence.

Introductory Guidance

8.0.1 Shari`ah defines a set of rules and principles governing the overall Islamic financial system. A claim of compliance with these rules and principles is the most important factor differentiating Islamic insurance from conventional insurance and is of relevance to takāful participants and potential takāful participants both before and after the point of contract formation. Accordingly, a TO’s commitment to comply with Shari`ah rules and principles is an essential feature of its activities. It follows that an effective Shari`ah governance framework is required to ensure that this commitment is upheld.

8.0.2 The approaches of jurisdictions to the application of Shari`ah currently vary. Some jurisdictions may have or establish a centralised Shari`ah board or committee (sometimes, but not always, embedded within the supervisor) that provides guidance and/or sets regulatory and Shari`ah parameters for Islamic financial products in the market. Others may place responsibility on the TO to obtain approval from an appropriate Shari`ah board, or to disclose if it has received approval from a Shari`ah board. Still others may not specify a requirement for a Shari`ah board, but require TOs to take due steps to ensure that their products and services are Shari`ah-compliant.10 This TCP is applicable, with necessary modifications, in all cases.

10 IFSB-10: Guiding Principles on Shari`ah Governance Systems in Institutions offering Islamic Financial Services covers the relationship between Shari`ah governance in individual institutions and whatever Shari`ah governance arrangements may exist for a jurisdiction as a whole. It recognises that Shari`ah governance may take several forms, and that jurisdictions have adopted diverse approaches to it. TCP 8 and its associated standard and guidance material have been prepared within that context and accommodate whatever Shari`ah governance arrangements consistent with IFSB-10 that may apply in an institution or jurisdiction. The Shari`ah board of the IFSB considers, however, that a Shari`ah board is necessary in all cases.
The ultimate accountability for maintenance of an effective Sharī`ah governance framework for a TU rests with the board of the TO. It is typical for the board to delegate oversight of Sharī`ah governance to a Sharī`ah board (or similarly named organ of Sharī`ah governance) comprised of or including one or more Sharī`ah scholars, or to an external Sharī`ah consultancy firm. Delegation of oversight does not detract from the board’s accountability.

The supervisory authority determines its general approach to the supervision of Sharī`ah governance in its jurisdiction, and decides upon components of its process for conduct of supervision.

Objectives of the Sharī`ah Governance Framework

The supervisor requires a TO to maintain a governance structure, policies and procedures designed to ensure that the Sharī`ah rules and principles are adhered to in all aspects of the operations of the TU, including products and services.

This requirement applies in respect of an undertaking or window representing itself as “takāful” or “Islamic insurance”, either expressly or by implication.

A “Sharī`ah governance framework” refers to the set of institutional and organisational arrangements that is required to ensure there is effective and independent oversight of Sharī`ah compliance through structures maintained by the legal entity and processes carried out by it or at its direction.

Elements of a Sharī`ah governance framework may include one or more of the following:

- the issuance of relevant Sharī`ah pronouncements or resolutions;
- a Sharī`ah risk management function to identify, measure, monitor and report Sharī`ah non-compliance risks in the operations of the TU;
- the dissemination of information on such Sharī`ah pronouncements or resolutions to the operative personnel who monitor day-to-day Sharī`ah compliance;
- an internal Sharī`ah compliance review or audit to verify that the Sharī`ah compliance requirements have been satisfied, during which any non-compliance is recorded, reported, addressed and rectified, or imposing the consequence of invalidation on it where it cannot be rectified; and
- an annual external Sharī`ah compliance review or audit to verify that the internal Sharī`ah compliance review or audit has been carried out properly and the findings have been duly noted by the Sharī`ah board.
8.1.4 The Sharī`ah governance structure adopted by a TO should be proportionate, with regard to the size, complexity and nature of its business. For example, the Sharī`ah board of a large TO could include several scholars, and the TO might have a separate unit for Sharī`ah compliance testing and audit, while a small operation might rely upon one appropriately qualified scholar, and integrate its Sharī`ah compliance testing and audit with its compliance and internal audit frameworks.

8.1.5 The scope of a TO’s Sharī`ah governance framework should cover both relevant ex-ante and relevant ex-post processes. Ex-ante processes cover those for the issuance of Sharī`ah pronouncements and resolutions, and pre-approvals of products before they are offered to customers, or of other contracts before they are entered into. Ex-post processes include internal and external Sharī`ah compliance review and reporting, and actions to remediate detected non-compliance.

8.1.6 The supervisor should require a TO to ensure that its operations and products claimed to be Sharī`ah-compliant have undergone a credible Sharī`ah screening and approval process and/or conform with the jurisdiction’s centralised Sharī`ah standards (if applicable).

8.1.7 The supervisor may refuse to permit a TO to represent its business as Sharī`ah-compliant where the supervisor is not satisfied as to the adequacy of the TO’s Sharī`ah governance framework.

8.1.8 The supervisor should require a TO to make appropriate disclosures should any material changes occur affecting the Sharī`ah compliance of a product previously promoted as Sharī`ah-compliant.

Suitability

8.2 The supervisor requires a TO to demonstrate competence and operational independence of its Sharī`ah board and of other persons with significant responsibilities for Sharī`ah governance.

8.2.1 The competence and operational independence of the Sharī`ah board (or those others responsible for Sharī`ah governance) require the TO to be able to demonstrate the following characteristics:

- members of the Sharī`ah board possess, collectively, adequate skills and experience in the application of Sharī`ah in financial services and in takāful of the type or types concerned;
- each member of the Sharī`ah board has sufficient time to devote to the exercise of that member’s duties, taking into account the member’s commercial, academic and other commitments;
- members of the Sharī`ah board are able to provide objective decisions on matters on which they opine, including that:
o members of the Sharī`ah board do not have operational responsibility for the business upon which the Sharī`ah board is opining; and
o members of the Sharī`ah board are required to recuse themselves from opining where their personal independence may be compromised;
- each member of the Sharī`ah board has good understanding of professional ethics and conduct; and
- measures are in place to address any misaligned incentives and conflicts of interest of the Sharī`ah board, including the role of Sharī`ah scholars.

8.2.2 The supervisor requires members of the Sharī`ah board to meet fit and proper requirements as described in TCP 5: Suitability of Persons. The supervisor may make available evaluation criteria for the assessment of the qualifications and other fitness and propriety requirements of Sharī`ah board members.

8.2.3 Persons other than members of the Sharī`ah board who have significant responsibilities for the performance of the Sharī`ah governance system are required to meet fit and proper requirements applicable to senior management or key persons in control functions as appropriate, as described in TCP 5: Suitability of Persons. The supervisor may make available evaluation criteria for the assessment of the qualifications and other fitness and propriety requirements of such persons.

Effectiveness of Sharī`ah Governance Framework

8.3 The supervisor requires a TO to ensure that its Sharī`ah governance framework operates effectively.

8.3.1 The supervisor expects each TO to be able to demonstrate, among other things:
- clear terms of reference regarding the Sharī`ah board’s mandate and responsibility;
- well-defined operating procedures and lines of reporting for the Sharī`ah board; and
- an appropriate and transparent process for resolving any differences of opinion between the board and the Sharī`ah board.

8.3.2 The mandate of the Sharī`ah board includes an appropriate mechanism for: issuing *fatāwa* (i.e. Sharī`ah pronouncements or resolutions); if necessary obtaining rulings from other Sharī`ah scholars; applying *fatāwa* it has issued, obtained or that the TO is otherwise required to observe; and monitoring Sharī`ah compliance in all aspects of the business operations of the TU.
8.3.3 Where Shari‘ah pronouncements and resolutions provide approval on grounds involving circumstances applicable to the TU, the governance framework should include provision for periodic re-evaluation of those circumstances to determine whether they remain applicable. For example, where a Shari‘ah approval is given on the basis of *dharura* (necessity), the approval should be time-limited and should be revisited at the end of that time, or earlier if circumstances are perceived to have changed, to consider whether the basis of *dharura* is still present.

8.3.4 The Shari‘ah board should have full access to the internal Shari‘ah compliance unit or department and internal Shari‘ah review or audit unit/department, to enable the Shari‘ah board to assess whether internal control and compliance procedures have been appropriately followed and that applicable rules and regulations to which the TO is subject have been complied with.

8.3.5 The supervisor should require a TO to facilitate continuing professional development of Shari‘ah board members, and of other personnel engaged in aspects of Shari‘ah governance. The TO should give consideration to the training needs of those charged with performance of functions related to Shari‘ah compliance.

8.3.6 The supervisor may require periodic formal assessment by the board of the effectiveness of a TO’s Shari‘ah board as a whole and of the contribution by each member to the effectiveness of the Shari‘ah board. Such an assessment should be conducted in accordance with criteria established by the board, and the result of the assessment submitted to the board.

**TCP 9: RISK MANAGEMENT AND INTERNAL CONTROLS**
The supervisor requires a TO to have, as part of its overall corporate governance framework, effective systems of risk management and internal controls, including effective functions for risk management, compliance, actuarial matters and internal audit.

**Introductory Guidance**

9.0.1 As part of the overall corporate governance framework and in furtherance of the safe and sound operation of the TU and the protection of *takāful* participants, the board is ultimately responsible for ensuring that the TO has in place effective systems of risk management and internal controls and functions to address the key risks it faces and for the key legal and regulatory obligations that apply to it. Senior management effectively implements these systems and provides the necessary resources and support for these functions.
9.0.2 In some jurisdictions, risk management is considered a subset of internal controls, while other jurisdictions would see it the other way around. The two systems are in fact closely related. Where the boundary lies between risk management and internal controls is less important than achieving, in practice, the objectives of each.

9.0.3 The systems and functions should be adequate for the TO’s objectives, strategy, risk profile, and the applicable legal and regulatory requirements. They should be adapted as the TU’s business and internal and external circumstances change.

9.0.4 The nature of the systems that the TO has is dependent on many factors. The systems typically include:

- strategies setting out the approach of the TO for dealing with specific areas of risk and legal and regulatory obligations;
- policies defining the procedures and other requirements that members of the board and employees need to follow;
- processes for the implementation of the TO’s strategies and policies; and
- controls to ensure that such strategies, policies and processes are in fact in place, are being observed and are attaining their intended objectives.

9.0.5 A TO’s functions (whether in the form of a person, unit or department) should be properly authorised to carry out specific activities relating to matters such as risk management, compliance, actuarial matters and internal audit. These functions are generally referred to as control functions.

Special Considerations for Takāful

9.0.6 In the case of takāful operated according to a principle of segregation of funds with different stakeholders, risk management and internal controls need to reflect the fact that the incidence of risks may fall partly on the takāful funds (including any investment funds attributable to takāful participants, and partly on the funds attributable to the TO). The TO has a responsibility to manage not only its own risks but those affecting the interests of the takāful participants, whose funds it manages.

9.0.7 It is a key feature of takāful that its operations and contracts are intended to be in compliance with the Shari‘ah. A TO has therefore to manage the risk of Shari‘ah non-compliance. While the supervisor may not be specifically tasked with ensuring Shari‘ah compliance in the takāful sector, the confidence of existing and potential takāful participants is a factor in the stability of this sector and is therefore relevant to supervisory objectives. TCP 8: Shari‘ah Governance provides standards and guidance materials for supervisors.
Special Considerations for Groups

9.0.8 Group-wide risks may affect TUs within a group, while risks at the TU level could also affect the group as a whole. To help address this, groups should have a strong risk management and compliance culture across the group and at the TU level. Thus, in addition to meeting group governance requirements, the group should take into account the obligations of its TU to comply with local laws and regulations.

9.0.9 How a group’s systems of risk management and internal controls are organised and operate will depend on the governance approach the group takes – that is, whether it takes a more centralised or a more decentralised approach (see the IAIS Issues Paper on Approaches to Group Corporate Governance; impact on control functions). Regardless of the governance approach, it is important that effective systems of risk management and internal controls exist and that risks are properly monitored and managed at the TU level and on a group-wide basis.

9.0.10 Where a group includes takāful operations, the impact of group-wide risks on the takāful operations may be different from the impact on conventional insurers within the group. For example, risks might be considered mitigated at the group level by diversification in the conventional part of the group, but must in takāful be considered separately for the segregated funds, making the group-level impression misleading. Group risk controllers may also be unfamiliar with requirements specific to TUs (e.g. the necessity of Sharī`ah compliance in assets, and the requirement for correct attribution of income and expenses between segregated funds) or in the particular jurisdiction of a TU. Centralisation of risk management may therefore be less effective for a group that contains takāful operations.

9.0.11 Additionally, a group’s governance approach will also affect the way in which its control functions are organised and operated. Coordination between the TU and group control functions is important to help ensure overall effective systems of risk management and internal controls. Regardless of how the group control functions are organised and operated, the result should provide an overall view of the group-wide risks and how they should be managed.

9.0.12 Supervisors should require the establishment of comprehensive and consistent group governance and assess its effectiveness. While the group-wide supervisor is responsible for assessing the effectiveness of the group’s systems of risk management and internal controls, the other involved supervisors undertake such assessments on a legal entity basis. Appropriate supervisory cooperation and coordination is necessary to have a group-wide view and to enhance the assessment of the legal entities.

9.0.13 Cooperation and communication between the supervisor or supervisors of takāful operations in a group and supervisors of other group members
(and, in particular, the group-wide supervisor) is essential for the formation of a proper group-wide view of the risks in the group and their incidence.

Systems for Risk Management and Internal Controls

9.1 The supervisor requires the TO to establish, and operate within, an effective and documented risk management system, which includes, at least:

- a risk management strategy that defines the TU's risk appetite;
- a risk management policy outlining how all material risks are managed within the risk appetite; and
- the ability to respond to changes in the TU's risk profile in a timely manner.

Basic Components of a Risk Management System

9.1.1 The risk management system is designed and operated at all levels of the TU to allow for the identification, assessment, monitoring, mitigation and reporting of all risks of the TU in a timely manner. It takes into account the probability, potential impact and time horizon of risks.

9.1.2 An effective risk management system should:

- take into account the TO's overall business strategy and business activities (including any business activities which have been outsourced);
- provide that the TU's risk appetite, expressed in a risk appetite statement, be aligned with the TO's business strategy and embedded in its day-to-day activities;
- provide relevant objectives, key principles and proper allocation of responsibilities for dealing with risk across the business areas and business units of the TO;
- provide explanations of the methodologies, key assumptions and limitations of risk management; for groups this would include the rationale as to the risk appetite for different individual TUs and insurance legal entities within the group;
- provide a documented process defining the board approval required for any deviations from the risk management strategy or the risk appetite and for settling any major interpretation issues that may arise;
- define and categorise material risks (by type) to which the TU is exposed, at both TU and group level where applicable, and the levels of acceptable risk limits for each type of risk;
- include documented policies that describe how categories of risks are managed and the specific obligations of employees and the TO in dealing with risk, including risk escalation and risk mitigation tools;
- provide suitable processes and tools (including stress testing and, where appropriate, models) for identifying, assessing, monitoring and reporting on risks. Such processes should also cover contingency planning;
• provide for regular reviews of the risk management system (and its components) to help ensure that necessary modifications and improvements are identified and made in a timely manner; and
• appropriately address other matters related to risk management for solvency purposes set out in TCP 16: *Enterprise Risk Management for Solvency Purposes*.

9.1.3 The risk management system should cover at least the following risks: underwriting and reserving, asset–liability management, investments, liquidity, concentration, Shari‘ah non-compliance, operational and conduct, as well as risk mitigation techniques including the use of *retakāful* (and, where permitted, conventional reinsurance). TCP 13 addresses issues related to *retakāful* in more detail.

**Scope and Embedding of the Risk Management System**

9.1.4 The risk management system should be aligned with the TO’s risk culture and embedded into the various business areas and units with the aim of having the appropriate risk management practices and procedures embedded in the key operations and structures.

**Identification and Assessment**

9.1.5 The risk management system should take into account all reasonably foreseeable and relevant material risks to which the TU is exposed, both at the TU and the individual business unit levels. This includes current and emerging risks.

9.1.6 TOs should assess material risks both qualitatively and, where appropriate, quantitatively. Appropriate consideration should be given to a sufficiently wide range of outcomes, as well as to the appropriate tools and techniques to be used. The interdependencies of risks should also be analysed and taken into account in the assessments.

9.1.7 In the case of TUs operating on a basis of segregation of funds, the materiality of each risk should be assessed having regard to its incidence. For example, an investment loss may (if the risk crystallises) be material to the investment funds attributable to *takāful* participants, even if it is not material to the TO or to the TU as a whole. Some risks are more qualitative than quantitative – for example, the risk of accepting coverage for impermissible property into a *takāful* fund. The TO’s risk appetite statement should reflect the incidence of the risks. Further guidance on risk appetite statements is provided at TCP 16: *Enterprise Risk Management for Solvency Purposes*.

9.1.8 The TO’s risk assessment should be documented, including detailed descriptions and explanations of the risks covered, the approaches used, and the key judgments and assumptions made.

**Monitoring**
9.1.9 TOs should have in place adequate processes, controls and systems to assess the risks of new products and carry out a risk assessment before entering into new business lines and products. Significant new or changed activities and products that may increase an existing risk or create a new type of exposure should be approved by senior management and/or by the board and, with respect to Shari`ah non-compliance risk, by the Shari`ah board.

9.1.10 The risk management system should include processes and tools for monitoring risk, such as early warnings or triggers that allow timely consideration of, and adequate response to, material risks.

9.1.11 In the case of Shari`ah non-compliance risk, monitoring should take into account Shari`ah judgments made by the Shari`ah board and review the adequacy of existing monitoring processes when new judgments are made that may signify a change in the nature or extent of non-compliance risk.

**Mitigation**

9.1.12 The risk management system should include strategies and tools to mitigate against material risks. In most cases, a TO will control or reduce the risk to an acceptable level. Remedial action may be available for some risks – for example, purification of non-compliant income by charitable application. Another response to risk is to share the risk with a third party, or (subject to Shari`ah approval) to transfer the risk to a third party. If risks are not acceptable within the risk appetite and it is not possible to control, limit, remediate, share or transfer the risk, the TO should cease or change the activity that creates the risk.

**Reporting**

9.1.13 Risks, the overall assessment of risks and the related action plans should be reported to the board and/or to senior management, as appropriate, using qualitative and quantitative indicators and effective action plans. The TO's documented risk escalation process should allow for reporting on risk issues within established reporting cycles and outside of them for matters of particular urgency. Where matters relate to Shari`ah, reporting should also be made to the Shari`ah board in accordance with the legal entity's policies on Shari`ah governance. Board and/or senior management decisions on risks relating to Shari`ah compliance should be made following consultation with the Shari`ah board (or its delegate, where permitted in the documented risk escalation process) and after considering its advice.

9.1.14 The board should have appropriate ways to carry out its responsibilities for risk oversight. The risk management policy should therefore cover the content, form and frequency of reporting that it expects on risk from senior management and each of the control functions. Any proposed activity that
would go beyond the board-approved risk appetite should be subject to appropriate review and require board approval.

Risk Management Policy

9.1.15 The TO’s risk management policy should be written in a way to help employees understand their responsibilities regarding risk management. It should also reflect how the risk management system relates to the TO’s overall corporate governance framework and its corporate culture. Regular internal communications and training within the TO on the risk management policy may help in this regard.

9.1.16 The risk management policy should also reflect how the risk management system relates to the operating model adopted in a TU, recognising the interests of the different stakeholders and the obligation of the operation as a whole to maintain Sharī`ah compliance.

9.1.17 For insurance groups, a risk management policy addresses the way in which the group manages risks that are material at the insurance group level, including risks that arise from the insurance group being part of a wider group. For a TU that is part of a group, the risk management policy of that entity’s TO should address management of risks material at the entity level as well as additional risk it faces as a result of its membership in a group, which can encompass the widest group of which the TU is a member and not only the entity’s insurance group. Within an insurance group, the head of the group and the legal entities should ensure appropriate coordination and consistency between the head of the group and the legal entities when setting the risk management policy.

Changes to the Risk Management System

9.1.18 Both the board and senior management should be attentive to the need to modify the risk management system in light of changes in the TU’s risk profile as well as other new internal or external events and/or circumstances. The risk management system should include mechanisms to incorporate new risks and new information related to risk already identified on a regular basis. The risk management system should also be responsive to the changing interests and reasonable expectations of takāful participants and other stakeholders.

9.1.19 Material changes to a TO’s risk management system should be documented and be subject to approval by the board. The reasons for the changes should be documented. Appropriate documentation should be available to internal audit, external audit and the supervisor for their respective assessments of the risk management system.

9.1.20 In the context of a TU, mechanisms for identification of new risks should operate at the segregated fund level (where that model is adopted), because of the different risk profiles of stakeholders. The Sharī`ah board should be required to consider whether changing circumstances raise new
risks of Sharī`ah non-compliance. Proposals for amendment to the risk management system should be presented to the Sharī`ah board prior to approval by the board if the risks in question relate to Sharī`ah.

9.1.21 As part of its responsiveness to changes in the TU's risk profile, the risk management system should incorporate a feedback loop based on appropriate information, management processes and objective assessment. A feedback loop provides a process of assessing the effect of changes in risk leading to changes in risk management policy, risk limits and risk mitigating actions. This may help to ensure that decisions made by the board and senior management are implemented and their effects monitored and reported in a timely and sufficiently frequent manner.

9.1.22 Within an insurance group, there should be sufficient coordination and exchange of information between the head of the insurance group and its TOs and, where applicable, TUs as part of their respective feedback loops to ensure relevant changes in risk profiles can be taken into account.

9.2 The supervisor requires the TO to establish, and operate within, an effective and documented system of internal controls.

Basic Components of an Internal Control System

9.2.1 The internal control system should ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported (both internally and externally), and compliance with Sharī`ah requirements, laws, regulations, supervisory requirements and the TU's internal rules and decisions. It should be designed and operated to assist the board and senior management in the fulfilment of their respective responsibilities for oversight and management of the TU. Some TOs have a designated person or function to support the advancement, coordination and/or management of the overall internal control system on a more regular basis. Sharī`ah compliance may be monitored by a dedicated unit. TCP 8: Sharī`ah Governance provides more details on Sharī`ah governance frameworks.

9.2.2 The internal control system should cover all units and activities of the TU and should be an integral part of the daily activities of a TO. The controls should reflect the organisational structure of the takāful operation, and operate at the level of each segregated fund where the operation is organised on that basis. The controls should form a coherent system, which should be regularly assessed and improved as necessary. Each individual control of a TO, as well as all its controls cumulatively, should be designed for effectiveness and operate effectively.

9.2.3 An effective internal control system requires an appropriate control structure with control activities defined at every business unit level. Depending on the organisational structure of the TO, business or other
units should own, manage and report on risks and should be primarily accountable for establishing and maintaining effective internal control policies and processes. Control functions should determine and assess the appropriateness of the controls used by the business or other units. The internal audit function should provide independent assurance on the quality and effectiveness of the internal control system.\(^\text{11}\)

9.2.4 An effective internal control system typically includes the following controls.

**Segregation of Duties and Prevention of Conflicts of Interest**

- There is appropriate segregation of duties, and controls to ensure such segregation is observed. This includes, among other things, having sufficient distance between those accountable for a process or policy and those who check if an appropriate control exists for such a process or policy and whether it is being applied. It also includes having an appropriate distance between those who design or operate a control and those who check if such a control is effective in design and operation.

- There are up-to-date policies regarding who can sign for or commit the TU, and for what amounts, with corresponding controls (e.g. a practice that key decisions should be taken at least by two persons, with two or more signatures needed). Such policies and controls should be designed, among other things, to prevent any major transaction being entered into without appropriate governance review or by anyone lacking the necessary authority, and to ensure that borrowing, trading, risk and other such limits are strictly observed. Such policies should foresee a role for control functions – for example, by requiring, for major matters, the review and sign-off by risk management and compliance, and/or approval by a board-level committee.

**Policies and Processes**

- There are appropriate controls for all key business processes and policies, including for major business decisions and transactions (including intra-group transactions), critical IT functionalities, access to critical IT infrastructure by employees and related third parties, and important legal and regulatory obligations.

- There are appropriate controls for all transactions between segregated funds of a TU, and for the apportionment of items of revenue or expense between such segregated funds of a TU, and similarly for transactions or

\(^{11}\) This division of responsibilities between business, risk management and compliance, and internal audit is typically referred to as the three lines of defence. The business is considered as the first line of defence, the control functions (other than internal audit) as the second line of defence, and internal audit as the third line of defence. The business is deemed to "own" the controls, and the other lines of defence are there to help ensure their application and viability. Whatever approach is used, it is important that responsibilities be clearly allocated to promote checks and balances and avoid conflicts of interest.
apportionments between a *takāful* window and its host conventional insurer.

- There are policies on training in respect of controls, particularly for employees in positions of high trust or responsibility or involved in high risk activities.
- There is a centralised documented inventory of TO-wide key processes and policies, and of the controls in place in respect of such processes and policies, that also may introduce a hierarchy among the policies.

*Information and Communication*

- Appropriate controls exist to provide reasonable assurance of the accuracy and completeness of the TU's books, records and accounts, and of financial consolidation and reporting, including the reporting made to the TU's supervisors.
- There is adequate and comprehensive internal financial, operational and compliance data, as well as external market information about events and conditions that are relevant to decision making. Information should be reliable, timely and accessible, and be provided in a consistent format.
- Information processes cover all significant activities of the TU, including contingency arrangements.
- Effective channels of communication ensure that all staff fully understand and adhere to the internal controls and their duties and responsibilities, and that other relevant information is reaching the appropriate personnel.
- There are policies regarding escalation procedures.

*Monitoring and Review*

- Processes exist for regularly checking that the totality of all controls forms a coherent system and that this system works as intended; that it fits properly within the overall corporate governance and Shari`ah governance framework of the TU; and that it provides an element of risk control to complement the risk identification, risk assessment and risk management activities of the TO. As part of such review, individual controls are monitored and analysed periodically to determine gaps and improvement opportunities, with senior management taking such measures as are necessary to address these.
- Periodic testing and assessments are carried out by objective parties such as an internal or external auditor or a Shari`ah auditor to determine the adequacy, completeness and effectiveness of the internal control system and its utility to the board, Shari`ah board and senior management for controlling the operations of the TO.

*Responsibilities of the Board*

9.2.5 The board should have an overall understanding of the control environment across the various entities and businesses, and require senior management to ensure that for each key business process and policy, and related risks and obligations, there is an appropriate control.
9.2.6 The board of a TU should consult the Sharī‘ah board to inform its understanding of the control environment concerning Sharī‘ah non-compliance risk.

9.2.7 In addition, the board should ensure there is clear allocation of responsibilities within the TO, with appropriate segregation, including in respect of the design, documentation, operation, monitoring and testing of internal controls. Responsibilities should be properly documented, such as in charters, authority tables, governance manuals or other similar governance documents.

9.2.8 The board should determine which function or functions report to it or to any board committees in respect of the internal control system.

9.2.9 Reports in respect of the internal control system concerning Sharī‘ah non-compliance risk should be provided to the Sharī‘ah board. The responsibility for the control environment remains with the board.

Reporting

9.2.10 Reporting on the internal control system should cover matters such as:

- the strategy in respect of internal controls (such as responsibilities, target levels of compliance to achieve, validations and implementation of remediation plans);
- the stage of development of the internal control system, including its scope, testing activity, and the performance against the annual or periodic internal control system goals being pursued;
- an assessment of how the various business units are performing against internal control standards and goals;
- control deficiencies, weaknesses and failures that have arisen or that have been identified (including any identified by the internal or external auditors or the supervisor) and the responses thereto (in each case to the extent not already covered in other reporting made to the board); and
- controls at the appropriate levels so as to be effective, including at the process or transactional level.

Control Functions (General)

9.3 The supervisor requires the TO to have effective control functions with the necessary authority, independence and resources.

9.3.1 As part of the effective systems of risk management and internal controls, TOs have control functions, including for risk management, compliance, actuarial matters and internal audit. Control functions add to the governance checks and balances of the TO and provide the necessary assurance to the board in the fulfilment of its oversight duties.

9.3.2 The existence of control functions does not relieve the board or senior management of their respective governance and related responsibilities.
The control functions should be subject to periodic review either by the internal audit function (for control functions other than internal audit) or an objective external reviewer.

These provisions apply also in respect of control functions relating to Shari'ah non-compliance risk, for which further considerations are contained in TCP 8: Shari'ah Governance.

Appointment and Dismissal of Heads of Control Functions

The appointment, performance assessment, remuneration, discipline and dismissal of the head of control functions should be done with the approval of, or after consultation with, the board or the relevant board committee. For the head of the internal audit function, the appointment, performance assessment, remuneration, discipline and dismissal should be done by the board, its chair or the audit committee.

The TO should notify the supervisor of the reasons for dismissal of heads of control functions.

Authority and Independence of Control Functions

The board should approve the authority and responsibilities of each control function to allow each control function to have the authority and independence necessary to be effective.

The authority and responsibilities of each control function should be set out in writing and made part of, or referred to in, the governance documentation of the TO. The head of each control function should periodically review such document and submit suggestions for any changes to senior management and the board for approval, where appropriate.

A control function should be led by a person of appropriate level of authority. The head of the control function should not have operational business line responsibilities.

TOs should organise each control function and its associated reporting lines into the TO’s organisational structure in a manner that enables such function to operate and carry out their roles effectively. This includes direct access to the board or the relevant board committee.

Notwithstanding the possibility for TOs to combine certain control functions, a control function should be sufficiently independent from senior management and from other functions to allow its staff to:
- serve as a component of the TO’s checks and balances;
- provide an objective perspective on strategies, issues and potential violations related to their areas of responsibility; and
9.3.12 Each control function should avoid conflicts of interest. Where any conflicts remain and cannot be resolved with senior management, these should be brought to the attention of the board for resolution.

9.3.13 Each control function should have the authority to communicate on its own initiative with any employee and to have unrestricted access to information in any business unit that it needs to carry out its responsibilities. The control functions should have the right to conduct investigations of possible breaches and to request assistance from specialists within the TO (e.g. legal and internal audit), or engage external specialists to perform the task. The control functions should be free to report to senior management or the board on any irregularities or possible breaches disclosed by its investigations, without fear of retaliation or disfavour from management.

**Resources and Qualifications of the Control Functions**

9.3.14 Each control function should have the resources necessary to fulfil its responsibilities and achieve the specific goals in its areas of responsibility. This includes qualified staff and appropriate IT/management information processes. The function should be organised in an appropriate manner to achieve its goals.

9.3.15 The head of each control function should review regularly the adequacy of the function's resources and request adjustments from senior management as necessary. Where the head of a control function has a major difference of opinion with senior management on the resources needed, the head of the control function should bring the issue to the board or relevant board committee for resolution.

9.3.16 Persons who perform control functions should be suitable for their role and meet any applicable professional qualifications and standards. Higher expectations apply to the head of each control function. Persons who perform control functions should receive regular training relevant to their role to remain up to date on the developments and techniques related to their areas of responsibility.

**Board Access and Reporting by the Control Functions; Board Assessment of Control Functions**

9.3.17 The board should grant the head of each control function the authority and responsibility to report periodically to it or one of its committees. The board should determine the frequency and depth of such reporting so as to permit timely and meaningful communication and discussion of material matters. The reporting should include, among other things:
* information as to the function’s strategy and longer-term goals and the progress in achieving these;
• annual or other periodic operational plans describing shorter-term goals and the progress in achieving these; and
• resources (such as personnel, budget, etc.), including an analysis of the adequacy of these resources.

9.3.18 In addition to periodic reporting, the head of each control function should have the opportunity to communicate directly and to meet periodically (without the presence of management) with the chair of any relevant board committee (e.g. audit or risk committee) and/or with the chair of the full board. The board should periodically assess the performance of each control function. This may be done by the full board, by the chair of the board, by the relevant board committee or by the chair of the relevant board committee.

Risk Management Function

9.4 The supervisor requires the TO to have an effective risk management function capable of assisting the TO to:
• identify, assess, monitor, mitigate and report on its key risks in a timely way; and
• promote and sustain a sound risk culture.

9.4.1 A robust risk management function that is well positioned, resourced and properly authorised and staffed is an essential element of an effective risk management system. Within some TOs, and particularly at larger or more complex ones, the risk management function is typically led by a chief risk officer.

Access and Reporting to the Board by the Risk Management Function

9.4.2 The risk management function should have access and provide written reports to the board as required by the board, typically on matters such as:
• an assessment of risk positions and risk exposures and steps being taken to manage them;
• an assessment of changes in the TU’s risk profile relative to risk appetite;
• where appropriate, an assessment of pre-defined risk limits;
• where appropriate, risk management issues resulting from strategic affairs such as corporate strategy, mergers and acquisitions, and major projects and investments; and
• an assessment of risk events and the identification of appropriate remedial actions.

9.4.3 The head of the risk management function should have the authority and obligation to inform the board promptly of any circumstance that may have a material effect on the risk management system of the TO.

Main Activities of the Risk Management Function
The risk management function should establish, implement and maintain appropriate mechanisms and activities, including to:

• assist the board and senior management in carrying out their respective responsibilities, including by providing specialist analyses and performing risk reviews;

• identify the individual and aggregated risks (actual, emerging and potential) the TU faces;

• assess, aggregate, monitor and help manage and otherwise address identified risks effectively; this includes assessing the TU’s capacity to absorb risk with due regard to the nature, probability, duration, correlation and potential severity of risks;

• gain and maintain an aggregated view of the risk profile of the TU both at a legal entity and/or group-wide level;

• establish a forward-looking assessment of the risk profile;

• evaluate the internal and external risk environment on an ongoing basis in order to identify and assess potential risks as early as possible. This may include looking at risks from different perspectives, such as by territory or by line of business;

• consider risks arising from remuneration arrangements and incentive structures;

• conduct regular stress testing and scenario analyses as defined in TCP 16: Enterprise Risk Management for Solvency Purposes;

• regularly provide written reports to senior management, key persons in control functions and the board on the TU’s risk profile and details on the risk exposures facing the TU and related mitigation actions as appropriate;

• document and report material changes affecting the TO’s risk management system to the board to help ensure that the system is maintained and improved; and

• conduct regular self-assessments and implement or monitor the implementation of any needed improvements.

Matters Relating to Sharī`ah Governance

For activities of the risk management function that relate to Sharī`ah compliance, the risk management function should also provide reports on such matters to the Sharī`ah board.

Compliance Function

The supervisor requires the TO to have an effective compliance function capable of assisting the TO to: (i) meet its legal, regulatory and supervisory obligations; and (ii) promote and sustain a compliance culture, including through the monitoring of related internal policies.

The compliance function has a broader role than merely monitoring compliance with laws, regulations and supervisory requirements; monitoring compliance with internal policies, and promoting and sustaining
a compliance culture within the TO, are equally important aspects of this control function.

9.5.2 Compliance starts at the top. The board is ultimately responsible for establishing standards for honesty and integrity throughout the TO and for creating an effective corporate culture that emphasises them. This should include a code of conduct or other appropriate mechanism as evidence of the TO's commitment to comply with all applicable laws, regulations, supervisory requirements and internal policies, and to conduct its business ethically and responsibly.

9.5.3 As part of this commitment, the TO has in place a robust and well-positioned, resourced and properly authorised and staffed compliance function. Within some TOs, particularly larger or more complex ones, such a function is typically led by a chief compliance officer.

9.5.4 The compliance function should have access to appropriately skilled resources for the conduct of compliance assessments related to Shari‘ah. A TU may have a separate unit performing Shari‘ah compliance work. Where this is the case, the Shari‘ah compliance unit should cooperate with the compliance function to ensure that the scope of neither team’s activity is impaired by the separation of their duties.

Board Access and Reporting of the Compliance Function

9.5.5 The compliance function should have access and provide written reports to senior management, key persons in control functions and the board on matters such as:

- an assessment of the key compliance risks the TU faces and the steps being taken to address them;
- an assessment of how the various parts of the TU (e.g. divisions, major business units, product areas) are performing against compliance standards and goals;
- any compliance issues involving management or persons in positions of major responsibility within the TO, and the status of any associated investigations or other actions being taken;
- material compliance violations or concerns involving any other person or unit of the TU and the status of any associated investigations or other actions being taken; and
- material fines or other disciplinary actions taken by any regulator or supervisor in respect of the TO or any employee.

9.5.6 The head of the compliance function should have the authority and obligation to inform promptly the chair of the board directly in the event of any major non-compliance by a member of management or a material non-compliance by the TU with an external obligation if in either case they believe that senior management or other persons in authority at the TO are not taking the necessary corrective actions and a delay would be detrimental to the TU or its takāful participants.
9.5.7 Sharī`ah compliance reports should be communicated to the Sharī`ah board. Sharī`ah compliance reports should, however, also form a part of compliance reports by the compliance function to the board, senior management and persons in key control functions, and fall within the obligation of the head of the compliance function to report major non-compliance to the chair of the board.

*Main Activities of the Compliance Function*

9.5.8 The compliance function should establish, implement and maintain appropriate mechanisms and activities, including to:

- promote and sustain an ethical corporate culture that values responsible conduct and compliance with internal and external obligations; this includes communicating and holding training on an appropriate code of conduct or similar that incorporates the corporate values of the TO, aims to promote a high level of professional conduct and sets out the key conduct expectations of employees;
- identify, assess, report on and address key legal and regulatory obligations, including obligations to the TU’s supervisor, and the risks associated therewith; such analyses should use risk and other appropriate methodologies;
- ensure the TO monitors and has appropriate policies, processes and controls in respect of key areas of legal, regulatory and ethical obligation;
- hold regular training on key legal and regulatory obligations, particularly for employees in positions of high responsibility or who are involved in high-risk activities;
- facilitate the confidential reporting by employees of concerns, shortcomings, or potential or actual violations in respect of TO internal policies, legal or regulatory obligations, or ethical considerations; this includes ensuring there are appropriate means for such reporting;
- address compliance shortcomings and violations, including ensuring that adequate disciplinary actions are taken and any necessary reporting to the supervisor or other authorities is made; and
- conduct regular self-assessments of the compliance function and the compliance processes and implement or monitor needed improvements.

*Actuarial Function*

9.6 The supervisor requires the TO to have an effective actuarial function capable of evaluating and providing advice regarding, at least, technical provisions, premium and pricing activities, capital adequacy, reinsurance and compliance with related statutory and regulatory requirements.

9.6.1 A robust actuarial function that is well positioned, resourced and properly authorised and staffed is essential for the proper operation of the TU. It plays a key role as part of the TO’s overall systems of risk management and internal controls.
Board Access and Reporting of the Actuarial Function

9.6.2 The actuarial function should have access to and periodically report to the board on matters such as:

- any circumstance that may have a material effect on the TU from an actuarial perspective;
- the adequacy of the technical provisions and other liabilities;
- distribution of profits to participating policyholders;
- stress testing and capital adequacy assessment with regard to the prospective solvency position of the TU; and
- any other matters as determined by the board.

9.6.3 Written reports on actuarial evaluations should be made to the board, senior management, or other key persons in control functions or the supervisor as necessary or appropriate or as required by legislation.

Main Activities of the Actuarial Function

9.6.4 The actuarial function evaluates and provides advice to the TO on matters including:

- the TU’s takāful liabilities, including policy provisions and aggregate claim liabilities, as well as determination of reserves for financial risks;
- asset–liability management with regards to the adequacy and the sufficiency of assets and future revenues to cover the TU’s obligations to policyholders and capital requirements, as well as other obligations or activities;
- the TU’s investment policies and the valuation of assets;
- a TU’s solvency position, including a calculation of minimum capital required for regulatory purposes and liability and loss provisions;
- a TU’s prospective solvency position by conducting capital adequacy assessments and stress tests under various scenarios, and measuring their relative impact on assets, liabilities, and actual and future capital levels;
- risk assessment and management policies and controls relevant to actuarial matters or the financial condition of the TU;
- the fair treatment of policyholders with regard to distribution of profits awarded to participating policyholders;
- the adequacy and soundness of underwriting policies;
- the development, pricing and assessment of the adequacy of reinsurance arrangements;
- product development and design, including the terms and conditions of takāful contracts and pricing, along with estimation of the capital required to underwrite the product;
- the sufficiency, accuracy and quality of data, the methods and the assumptions used in the calculation of technical provisions;
- the research, development, validation and use of internal models for internal actuarial or financial projections, or for solvency purposes as in the own risk and solvency assessment (ORSA); and
9.6.5 Where required, the actuarial function may also provide to the supervisor certifications on the adequacy, reasonableness and/or fairness of premiums (or the methodology to determine the same) and certifications or statements of actuarial opinion.

9.6.6 The supervisor should clearly define when such certifications or statements of actuarial opinion need to be submitted to the supervisor. When these are required to be submitted, the supervisor should also clearly define both the qualifications of those permitted to certify or sign such statements and the minimum contents of such an opinion or certification.

Appointed Actuary

9.6.7 Some jurisdictions may require an “appointed actuary”, “statutory actuary” or “responsible actuary” (referred to here as an “appointed actuary”) to perform certain functions, such as determining or providing advice on a TU’s compliance with regulatory requirements for certifications or statements of actuarial opinion. The tasks and responsibilities of the appointed actuary should be clearly defined and should not limit or restrict the tasks and responsibilities of other individuals performing actuarial functions.

9.6.8 The TO should be required to report the appointed actuary’s appointment to the supervisor.

9.6.9 The appointed actuary should not hold positions within or outside of the TO that may create conflicts of interest or compromise their independence. If the appointed actuary is not an employee of the TO, the board should determine whether the external actuary has any potential conflicts of interest, such as if their firm also provides auditing or other services to the TU. If any such conflicts exist, the board should subject them to appropriate controls or choose another appointed actuary.

9.6.10 If an appointed actuary is replaced, the TO should notify the supervisor and give the reasons for the replacement. In some jurisdictions, such a notification includes statements from both the TO and the former appointed actuary as to whether there were any disagreements with the former appointed actuary over the content of the actuary’s opinion on matters of risk management, required disclosures, scopes, procedures or data quality, and whether or not any such disagreements were resolved to the former appointed actuary’s satisfaction.

9.6.11 In some jurisdictions, the appointed actuary also has the obligation to notify the supervisor if they resign for reasons connected with their duties as an appointed actuary or with the conduct of the TU’s business and give the reasons for resigning. The appointed actuary should also notify the
supervisor and provide an explanation if their appointment is revoked by the TO.

9.6.12 The supervisor should have the authority to require a TO to replace an appointed actuary when such person fails to adequately perform required functions or duties, is subject to conflicts of interest or no longer meets the jurisdiction's eligibility requirements.

Internal Audit Function

9.7 The supervisor requires the TO to have an effective internal audit function capable of providing the board with independent assurance in respect of the quality and effectiveness of the TO's corporate governance framework.

9.7.1 One of the oversight roles of the board is to ensure that the information provided by the internal audit function allows the board to effectively validate the effectiveness of the internal control system.

9.7.2 The internal audit function should provide independent assurance to the board through general and specific audits, reviews, testing and other techniques in respect of matters such as:

- the overall means by which the TO preserves its assets and those of takāful participants, and seeks to prevent fraud, misappropriation or misapplication of such assets;
- the reliability, integrity and completeness of the accounting, financial and risk reporting information, as well as the capacity and adaptability of IT architecture to provide that information in a timely manner to the board and senior management;
- the design and operational effectiveness of the TO's individual controls in respect of the above matters, as well as of the totality of such controls (the internal control system);
- other matters as may be requested by the board, senior management, the supervisor or the external auditor; and
- other matters which the internal audit function determines should be reviewed to fulfil its mission, in accordance with its charter, terms of reference or other documents setting out its authority and responsibilities.

9.7.3 The internal audit function should have access to appropriately skilled resources for the conduct of internal audit procedures related to Shari`ah. A TO may have a separate unit performing Shari`ah audit work. Where this is the case, the Shari`ah audit unit should cooperate with the internal audit function to ensure that the scope of neither team's activity is impairs by the separation of their duties.

9.7.4 In addition to the matters set out in Guidance paragraph 9.7.2, the scope of the Shari`ah audit would include the provision of assurance on the means by which the TO ensures the Shari`ah compliance of its operations and contracts, and any other matters requested by the Shari`ah board.
Authority and Independence of the Internal Audit Function

9.7.5 To help ensure objectivity, the internal audit function is independent from management and other control functions and is not involved operationally in the business. The internal audit function’s ultimate responsibility is to the board, not management. To help ensure independence and objectivity, the internal audit function should be free from conditions that threaten its ability to carry out its responsibilities in an unbiased manner. In carrying out its tasks, the internal audit function forms its judgments independently. If necessary, the internal audit function should consider the need to supplement its own assessment with third-party expertise in order to make objective and independent decisions.

9.7.6 The board should grant suitable authority to the internal audit function, including the authority to:
- access and review any records or information of the TO which the internal audit function deems necessary to carry out an audit or other review;
- undertake on the internal audit function’s initiative a review of any area or any function consistent with its mission;
- require an appropriate management response to an internal audit report, including the development of a suitable remediation, mitigation or other follow-up plan as needed; and
- decline doing an audit or review, or taking on any other responsibilities requested by management, if the internal audit function believes this is inconsistent with its mission or with the strategy and audit plan approved by the board. In any such case, the internal audit function should inform the board or the audit committee and seek their guidance.

Board Access and Reporting of the Internal Audit Function

9.7.7 The head of the internal audit function reports to the Board (or to any member who is not part of the management) or to the audit committee if one exists (or its chair). In its reporting, the internal audit function should cover matters such as:
- the function’s annual or other periodic audit plan, detailing the proposed areas of audit focus, and any significant modifications to the audit plan;
- any factors that may be adversely affecting the internal audit function’s independence, objectivity or effectiveness;
- material findings from audits or reviews conducted; and
- the extent of management’s compliance with agreed-upon corrective or risk mitigating measures in response to identified control deficiencies, weaknesses or failures, compliance violations or other lapses.

9.7.8 In addition to periodic reporting, the head of internal audit should be authorised to communicate directly, and meet periodically, with the head
of the audit committee or the chair of the board without management present.

9.7.9 Sharī`ah audit findings should be communicated to the Sharī`ah board. Sharī`ah audit findings should, however, also form a part of audit reports by the internal audit function to the board, to the audit committee (or its chair) or to the chair of the board without management present.

**Main Activities of the Internal Audit Function**

9.7.10 The audit function should carry out such activities as are needed to fulfil its responsibilities. These activities include:

- establishing, implementing and maintaining a risk-based audit plan to examine and evaluate alignment of the TO’s processes with their risk culture;
- monitoring and evaluating the adequacy and effectiveness of the TO’s policies and processes and the documentation and controls in respect of these, on a legal entity and group-wide basis and on an individual subsidiary, business unit, business area, department or other organisational unit basis;
- reviewing levels of compliance by employees, organisational units and third parties with laws, regulations and supervisory requirements, established policies, processes and controls, including those involving reporting;
- evaluating the reliability, integrity and effectiveness of management information processes and the means used to identify, measure, classify and report such information;
- monitoring that identified risks are effectively addressed by the internal control system;
- evaluating the means of safeguarding TU and takāful participants’ assets and, as appropriate, verifying the existence of such assets and the required level of segregation between assets of the TU (including assets held in takāful funds, segregated according to the takāful model adopted) and any other assets held that are attributable to takāful participants but that have not been attributed to a takāful fund;
- monitoring and evaluating the effectiveness of the TO’s control functions, particularly the risk management and compliance function; and
- coordinating with the external auditors and, to the extent requested by the board and consistent with applicable law, evaluating the quality of performance of the external auditors.

9.7.11 In carrying out the above tasks, the internal audit function should ensure that all material areas of risk and obligation of the TU are subject to appropriate audit or review over a reasonable period of time. Among these areas are those dealing with:
market, underwriting, credit, liquidity, operational, conduct of business, as well as reputational issues derived from exposure to those risks;

• accounting and financial policies and whether the associated records are complete and accurate;

• extent of compliance by the TU with applicable laws, regulations and supervisory requirements from all relevant jurisdictions;

• intra-group transactions, including intra-group risk transfer and internal pricing;

• adherence by the TO to the TO’s remuneration policy;

• the reliability and timeliness of escalation and reporting processes, including whether there are confidential means for employees to report concerns or violations and whether these are properly communicated, offer the reporting employee protection from retaliation, and result in appropriate follow-up; and

• the extent to which any non-compliance with internal policies or external legal or regulatory obligations is documented and appropriate corrective or disciplinary measures are taken, including in respect of individual employees involved.

9.7.12 Subject to applicable laws on record retention, the internal audit function should keep records of all areas and issues reviewed so as to provide evidence of these activities over time.

Outsourcing of Material Activities or Functions

9.8 The supervisor requires the TO to retain at least the same degree of oversight of, and accountability for, any outsourced material activity or function (such as a control function) as applies to non-outsourced activities or functions.

9.8.1 Outsourcing should not materially increase risk to the TU or materially adversely affect the TO’s ability to manage its risks and meet its legal and regulatory obligations.

9.8.2 The board and senior management remain responsible in respect of functions or activities that are outsourced.

9.8.3 The supervisor should require the board to have review and approval processes for outsourcing of any material activity or function and to verify, before approving, that there was an appropriate assessment of the risks, as well as an assessment of the ability of the TO’s risk management and internal controls to manage them effectively in respect of business continuity. The assessment should take into account to what extent the TU’s risk profile and business continuity could be affected by the outsourcing arrangement.

9.8.4 The supervisor should require TOs which outsource any material activity or function to have in place an appropriate policy for this purpose, setting out the internal review and approvals required and providing guidance on the contractual and other risk issues to consider. This includes considering
limits on the overall level of outsourced activities at the TO and on the number of activities that can be outsourced to the same service provider. Because of the particularly important role that control activities and control functions play in a TO’s corporate governance framework, the supervisor should consider issuing additional requirements for their outsourcing or dedicating more supervisory attention to any such outsourcing.

9.8.5 For the purposes of Guidance paragraphs 9.8.3 and 9.8.4, the functions of the Sharī`ah board, of Sharī`ah compliance and of Sharī`ah audit (if any) should be considered material activities or functions.

9.8.6 Outsourcing relationships should be governed by written contracts that clearly describe all material aspects of the outsourcing arrangement, including the rights, responsibilities and expectations of all parties. When entering into or varying an outsourcing arrangement, the board and senior management should consider, among other things:
• how the TU’s risk profile and business continuity will be affected by the outsourcing;
• the service provider’s governance, risk management and internal controls and its ability to comply with applicable laws and regulations;
• the service providers’ service capability and financial viability; and
• succession issues to ensure a smooth transition when ending or varying an outsourcing arrangement.

9.8.7 A TU that is a member of an insurance group may be expected by the group to outsource services to a particular service provider (internal to the group, or external) also used by conventional insurers within the group. When considering such an outsource arrangement, the board of the TU should not assume that assessments of that service provider performed by other group companies may be relied upon as regards to matters specific to takāful (e.g. Sharī`ah compliance and operation of segregated funds, where that model is applied). Where necessary, the board should perform its own assessment of the service provider.

9.8.8 In choosing an outsourcing provider, the board or senior management should be required to satisfy themselves as to the expertise, knowledge and skills of such provider, and its capacity to provide the outsourced services in light of other commitments, outsourced or otherwise, that it may have.

9.8.9 Outsourcing arrangements should be subject to periodic reviews. Periodic reports should be made to management and the board.

Considerations in Respect of Takāful Windows

9.8.10 Where a TU takes the form of a window, services or functions that are performed for the window by personnel of the “host” conventional insurer are, from the perspective of the window, outsourced to the host. Although the two are the same legal entity, and it is not possible for the relationship to be set out in a contract, it remains necessary for those responsible for
the governance of the window to have a clear view of the scope of the services that are performed for the window and the terms on which they are performed. The considerations in the guidance to Standard 9.8 are applicable, in a similar manner to which they apply in respect of intra-group outsourcing arrangements.

9.8.11 Those responsible for the governance of the window should consider relevant risks in the event that the same personnel undertake key functions for both the host insurer and the window. If, for example, the same underwriters assess both conventional insurance risks and takāful risks, those responsible for governance of the window should satisfy themselves that the governance framework provides for the underwriter to consider Sharī‘ah dimensions of the risk proposed to be underwritten, and the implications of any segregation of funds between those of the window as operator and those attributable to the takāful participants. The possibility of conflicts of interest between the window and the host should also be considered.

TCP 10: SUPERVISORY REVIEW AND REPORTING

The supervisor uses off-site monitoring and on-site inspections to: examine the business of each TU; evaluate its financial condition, conduct of business, corporate governance framework, Sharī‘ah governance framework and overall risk profile; and assess its compliance with relevant legislation and supervisory requirements. The supervisor obtains the necessary information to conduct effective supervision of TUs and evaluate the takāful market.

Introductory Guidance

10.0.1 This TCP focuses on the general processes and procedures supervisors should have in place with respect to supervisory review and reporting. For the purpose of this TCP, off-site monitoring and on-site inspections are collectively referred to as “supervisory review”. Aspects of what supervisors may require or assess as part of supervisory review and reporting on specific areas (such as solvency, governance, conduct of business) are dealt with in other TCPs with respect to those TCPs’ specific areas of focus.

10.0.2 Similarly, Sharī‘ah governance and aspects of takāful windows are dealt with in the TCPs on those topics.

10.0.3 Supervision is a dynamic process that includes:
- developing and implementing a framework for supervisory review and reporting;
- developing and executing supervisory plans for TUs;
- analysis of reported and other relevant information;
- feedback and dialogue between the supervisor and TOs;
• intervention, including any preventive/corrective measures or sanctions, where necessary;
• follow-up (including updating the supervisory framework and/or adjusting the frequency and intensity of assessment under supervisory plans); and
• cooperation and coordination with other relevant supervisors and authorities where necessary.

Framework for Supervisory Review and Reporting

10.1 The supervisor has a documented framework which outlines its approach for supervisory review and reporting. The supervisor reviews periodically that this framework remains effective and adequate.

10.1.1 While the framework should encompass all TOs within a jurisdiction, it should be sufficiently flexible with varying supervisory review and reporting requirements that allow for taking a risk-based approach. For example, the supervisory processes and activities which are appropriate for a complex, internationally active TU may be different from those for a small, local TU.

10.1.2 The framework should take into consideration the specificities of takāful as practised in the jurisdiction. In particular, where segregation of funds is practised, the framework should set out the supervisor’s approach to supervisory review and reporting at fund level. Different PRFs (or PIFs) may be exposed to different levels of risk depending on their business, in terms both of solvency and of conduct. The structure of charges between funds, the attribution of income and expenses between funds and capital support between funds (where provided), should also be covered within the framework.

10.1.3 In addition, Sharī‘ah non-compliance may have impacts from both the prudential perspective and that of conduct of business. The degree of responsibility that supervisors will have for supervising Sharī‘ah non-compliance varies from jurisdiction to jurisdiction. The framework should provide an approach to assessing the potential impact and the probability of Sharī‘ah non-compliance that is appropriate to the supervisor’s responsibility in this area.

10.1.4 The supervisor should have documented procedures and/or guidelines for consistent and regular supervisory review and reporting at an appropriate level of depth.

10.1.5 The supervisor should be able to process data in a timely and effective way and have processes and procedures to collect and store reported data securely in an electronic format. The framework should have the necessary protections for confidential information in the possession of the supervisor and for the sharing of information (see TCP 2: Supervisor and TCP 3: Information Sharing and Confidentiality Requirements).
10.1.6 The framework should enable the supervisor to coordinate on-site inspection and off-site monitoring activities. The supervisor should document the results of these activities in such a way that they are accessible and comprehensible to all involved staff.

10.1.7 The supervisor should establish both qualitative and quantitative methods for assessing TUs, in a consistent manner and on an ongoing basis. The supervisor should develop monitoring tools to identify potential risks within or affecting the TU or its customers in a timely manner.

10.1.8 The framework should enable the supervisor to evaluate the TU's business, financial condition, conduct of business and corporate governance framework to determine its overall risk profile. In order to achieve this objective, the supervisor should have an understanding of at least the TU's:
- takāful operational model, including the structure of any segregated funds;
- current and prospective solvency, including assets and liabilities, and off-balance sheet commitments;
- capital resources management, including any use of qardh (where applicable);
- technical operations (e.g. actuarial methods, underwriting policy, reinsurance/retakāful policy, investment profile);
- treatment of takāful participants and whether any activities being engaged in are not fair, lawful or proper, or appear inconsistent with the claim to Shari`ah compliance;
- corporate culture, business objectives and strategies, and business models;
- the systems of risk management and internal controls;
- organisational structure;
- Shari`ah governance function; and
- compliance with supervisory requirements.

10.1.9 The supervisor should assess the TU’s enterprise risk management framework for the identification and quantification of risks, and evaluate whether business activities and/or internal practices/processes reflect the TU’s risk assessment. The supervisor should compare the risk profile of the TU with its risk-carrying capacity and seek to detect issues that may adversely affect its capacity to meet obligations towards policyholders. The framework should enable the supervisor to analyse trends and compare risk assessments, including against any stress test outcomes.

10.1.10 The framework should include assessments of the risks to which TUs are exposed and the risks which TUs may pose to takāful participants, the takāful sector and financial stability. These assessments should include risks which may lead to a TU’s distress or disorderly failure or which may be transmitted through collective activities or exposures of a number of TUs and that may have a serious negative impact on financial stability (see TCP 24: Macroprudential Supervision).
10.1.11 The framework should include sufficiently comprehensive and regular communication between the supervisor and TOs. This communication should involve senior-level representatives as well as specialised areas within both the supervisor and TOs, and for insurance groups, may include contact with non-regulated and parent entities. Additionally, there should be appropriate communication channels between the supervisor and the external auditors for the exchange of information relevant to carrying out their respective statutory responsibilities.

10.1.12 The framework should promote pro-active and early intervention by the supervisor, in order to enable the TO to take appropriate action to mitigate risks and/or minimise current or future problems.

Review of the Framework

10.1.13 The supervisor’s review of its framework should pay due attention to the evolving risks which may be posed by TUs and the risks to which TUs may be exposed.

10.1.14 As part of the framework review, the supervisor should confer regularly internally as well as externally with other relevant authorities and stakeholders so that all relevant information is being appropriately assessed and analysed, and to facilitate the identification of potential new risks or emerging market trends that the framework may need to address. While the framework should be updated accordingly, the supervisor should be mindful that such updates are not done so frequently or in a manner that causes unnecessary disruption to the supervisory process and/or excessive costs to the supervisor and TUs.

10.1.15 The framework should be suitably flexible so that it may adapt easily and in a timely manner to domestic and global developments in, for example, legislation, the takāful and broader financial markets, or international standards. The framework should be able to accommodate changes in understanding of Sharī`ah in the jurisdiction, or adoption of pronouncements on Shari`ah recognised in the jurisdiction as authoritative.

Group Perspectives

10.1.16 The framework of the group-wide supervisor should take into account all entities identified within the scope of the insurance group (see TCP 23: Group-Wide Supervision). While insurance groups may have different approaches to governance structures – either more centralised or more decentralised – the framework should include appropriate tools for supervisory review and reporting for all relevant entities (see Issues Paper on Approaches to Group Corporate Governance).
10.1.17 Although the group-wide supervisor may not have the power to conduct supervisory review and reporting of non-regulated entities, it should assess, at least, the potential adverse impact of such non-regulated entities on the group.

10.1.18 Similarly, where the group-wide supervisor does not have the power to conduct supervisory review and reporting of a group legal entity in another jurisdiction, it should communicate and coordinate with the other involved supervisor accordingly. For example, the group-wide supervisor could approach the other involved supervisor to propose a joint on-site inspection or recommend that the other involved supervisor undertake such an inspection, when deemed necessary.

10.1.19 The group-wide supervisor’s framework should take account of the specificities of takāful in its approach to business of this nature. The approach of the group-wide supervisor to achieving this objective may vary, depending upon the materiality of takāful in the group. Takāful entities may in many cases be immaterial to the operations of the group; however, supervisors of takāful entities in the group should still assist the group-wide supervisor to understand the nature of this business, the function of Shari‘ah governance and the relevance of Shari‘ah non-compliance risk.

10.2 As part of the supervisory framework, the supervisor develops supervisory plans which set priorities and determine the appropriate depth and level of off-site monitoring and on-site inspection activity.

10.2.1 A supervisory plan is a tool for supervisors to determine the frequency, scope and depth of supervisory review activities. It could be generic (e.g. addressing categories or groups of TOs and insurers) or specific (addressing individual TOs).

10.2.2 In establishing a supervisory plan, the supervisor should assess and determine the key areas of risk to which TUs are exposed or risks which TUs may pose, using its judgment and the information, methodologies and tools at its disposal.

10.2.3 The circular nature of the supervisory framework provides a variety of inputs to help develop and/or adjust supervisory plans. For example, market analyses, internal models, TOs’ ORSA for TUs, horizontal reviews, stress/scenario testing, previous risk and conduct assessments, work of external auditors and information gathered as a result of supervisory reporting requirements provide information the supervisor should use as input in determining the scope and frequency of off-site monitoring and on-site inspections.

10.2.4 When developing and/or adjusting its supervisory plans, the supervisor also takes note of internal and external reports on the TO’s Shari‘ah risk management and compliance whether or not the supervisor has responsibility for supervision of Shari‘ah compliance.
10.3 The supervisor reviews outsourced material activities or functions to the same level as non-outsourced material activities or functions.

10.3.1 The supervisor should review outsourced material activities or functions through the TO itself, but should also obtain information from, and conduct on-site inspections of, entities engaged in providing outsourced activities or functions for the TO, where necessary.

10.3.2 The supervisory review process for outsourced material activities or functions may differ from the process used for non-outsourced activities or functions, provided that the supervisory outcomes are met.

10.3.3 Agreements between the TO and entities providing the outsourced material activities or functions should be drawn up in such a way that the supervisor’s ability to conduct its review is not restricted.

Supervisory Reporting

10.4 The supervisor:

- establishes documented requirements for the regular reporting of qualitative and quantitative information from all TOs licensed in its jurisdiction;
- defines the scope, content and frequency of the information to be reported;
- sets out the relevant accounting and auditing standards to be used;
- requires that an external audit opinion is provided on annual financial statements;
- requires TOs to report on any material changes or incidents that could affect their condition or customers;
- requires TOs to correct inaccurate reporting as soon as possible; and
- requires more frequent reporting and/or additional information from TOs as needed.

10.4.1 Supervisory reporting requirements should apply to all TOs licensed in a jurisdiction, and form the general basis for off-site monitoring. Supervisory reporting requirements are a reflection of the supervisor’s needs and will thus vary by jurisdiction according to overall market structure and conditions and by TU according to its nature, scale and complexity.

10.4.2 In setting supervisory reporting requirements, the supervisor may make a distinction for foreign TOs who are allowed to conduct takāful activities within the jurisdiction by way of a local branch or subsidiary or on a cross-border provision of services basis.

10.4.3 The supervisor should require TOs to report both quantitative and qualitative information, including at least:
• financial reports, which include at least a balance sheet and income statement as well as a statement of comprehensive income if appropriate;
• an external audit opinion on annual financial statements;
• off-balance sheet exposures;
• material outsourced functions and activities;
• a description of the TO’s organisational structure, corporate governance framework, and risk management and internal control systems; and
• information on complaints, claims, surrenders and lapses.

Where a supervisor has responsibility for supervising Sharī‘ah matters, it could also consider obtaining periodic statements from a TO’s Sharī‘ah board.

10.4.4 Where segregation of funds is practised, supervisory reporting should include the presentation of information at the level of each fund, including information on the assets, liabilities, technical balances and solvency position of that fund, as well as information on qardh used or available for use.

10.4.5 The supervisor should require TOs to utilise a consistent and clear set of instructions and definitions for any element in required reports that is not self-evident, in order to maximise comparability.

10.4.6 The supervisor may require that certain reports and information, such as solvency ratios or technical provisions, are subject to independent (internal or external) review, including audit and/or actuarial review.

10.4.7 While the supervisor sets out the relevant accounting and auditing standards to be used for supervisory reporting, the actual standards are generally established by a party other than the supervisor. To help accounting and auditing standards reflect the nature of takāful business, the supervisor could provide guidance and practices to be used for areas such as fair value estimations and technical provisions.

10.4.8 The external audit of the annual financial statements should be conducted in accordance with auditing standards that are generally accepted internationally.

10.4.9 The supervisor should consider using the work of external auditors in order to support the supervisory review process. For example, the supervisor may utilise the external audits to identify: internal control weaknesses and possible audit material risks; issues resulting from regulatory and accounting changes; changes in takāful and financial risks; and issues encountered in applying the audit approach.

10.4.10 The supervisor should require the external auditor to report matters that are likely to be of material significance without delay. Such matters
would include (indication of) material fraud and regulatory breaches or other significant findings identified in the course of the audit. Such information should be provided to the supervisor without the need for prior consent of the TO, and the external auditor should be duly protected from liability for any information disclosed to the supervisor in good faith.

10.4.11 Depending on the nature, scale and complexity of the TU, more frequent reporting and/or additional information may be requested from specific TOs on a case-by-case basis.

10.4.12 The supervisor should require that information on changes that could materially impact the TU's risk profile, financial position, organisational structure, governance or treatment of its customers is provided by the TO in a timely manner.

10.4.13 The supervisor should similarly require notification (where material) of changes that affect Sharī'ah governance, incidents of failure of Sharī'ah governance or incidents of Sharī'ah non-compliance. These matters are of relevance to the supervisor for reasons of prudential and conduct supervision, whether or not the supervisor is responsible for enforcement of Sharī'ah compliance.

10.4.14 The supervisor periodically reviews its reporting requirements to ascertain that they still serve their intended objectives and to identify any gaps which need to be filled. Assessing the results of off-site monitoring and on-site inspections may help to inform such a review.

Group Perspectives

10.4.15 The supervisor should require a TU which is part of an insurance group to describe its group reporting structure, and to provide timely notification of any material changes to that structure and significant changes or incidents that could affect the soundness of the insurance group. The description of the reporting structure should include information on the relationships between entities within the insurance group, and on the nature and volume of material intra-group transactions. The supervisor may require information on the impact on the TUs of being part of an insurance group.

10.4.16 Information to be provided on intra-group relationships should also include a description (where applicable) of Sharī'ah governance arrangements between entities within the insurance group, including any reliance on other group entities for pronouncements on Sharī'ah, Sharī'ah governance over operationalisation, and review of Sharī'ah compliance.

10.4.17 The supervisor may request and obtain relevant information about any entity within an insurance group, subject to applicable legal provisions and coordination with the supervisors of affected jurisdictions.

10.4.18 Where a group includes more than one TU, the supervisor should also consider whether the approach of the TOs concerned to Sharī'ah
governance and the application of Shari‘ah is consistent, particularly within the same jurisdiction. While material inconsistency between jurisdictions, or even within a jurisdiction, may simply reflect different approaches within a spectrum of acceptable or even mandatory practices, it may on the other hand indicate Shari‘ah governance or compliance risks.

10.4.19 The group-wide supervisor should establish its supervisory reporting requirements on a group-wide basis in coordination with the other involved supervisors. Such coordination may help the group-wide supervisor understand what information is being reported and avoid any gaps as well as facilitate the submission of information on group entities in other jurisdictions.

10.4.20 In order to better understand the group and its risks, the group-wide supervisor should require the group to submit information on the group structure, business operation and financial position of material entities within the insurance group and relationship among entities within the insurance group, including participation in other group entities and material intra-group transactions.

Off-Site Monitoring

10.5 The supervisor monitors TUs on an ongoing basis, based on communication with the TOs and analysis of information obtained through supervisory reporting as well as market and other relevant information.

10.5.1 The supervisor should be proactive and forward-looking in conducting effective off-site monitoring, and not rely only on historical data. The supervisor should analyse information obtained in a timely manner.

10.5.2 The results of off-site monitoring should influence the supervisory plan and help determine the content, nature, timing and frequency of on-site inspections. Off-site monitoring may also enable the early detection of problems so that prompt and appropriate supervisory responses can be taken before such problems become more serious.

10.5.3 Analysis by the supervisor may provide a deeper understanding of developing trends affecting a TU and its customers. Analysis by business lines, customer grouping and/or distribution channels may provide insights into the TU’s overall risk profile.

10.5.4 The supervisor should establish and follow documented procedures for the analysis and monitoring of the supervisory reporting that it receives. These procedures may be conducted by individual supervisory staff using monitoring tools and/or specialised resources, as appropriate.

10.5.5 Examples of ways in which this standard and its corresponding guidance can be pursued include those set out in the Annex to this TCP.

On-Site Inspection
10.6 The supervisor sets the objective, scope and timing for on-site inspections of TUs, develops corresponding work programmes and conducts such inspections.

10.6.1 On-site inspections help the supervisor to identify strengths and weaknesses within a TU, and to assess and analyse the risks to which a TU and its customers are exposed.

10.6.2 On-site inspections may supplement the analysis from off-site monitoring and provide the supervisor with the opportunity to verify information it has received. On-site inspection may also help to detect problems that may not be apparent through off-site monitoring. It is important that on-site inspections are coordinated with off-site monitoring to increase efficiency and avoid duplication of work.

10.6.3 On-site inspections should be tailored to the particular TU and its risks. However, an on-site inspection work programme should remain flexible since new priorities might arise.

10.6.4 The on-site inspection work programme should take account of the TU’s distribution model, the nature, size and profile of its customer base and its relative importance in the market. On-site inspections should be more frequent and more in-depth for TUs which are in a difficult financial position or where there is concern that their business practices pose a high risk of negative customer outcomes.

10.6.5 The planning of the on-site inspection work programme should also take account of the obligation on a TO to observe Shari‘ah compliance and maintain Shari‘ah governance. The supervisor’s responsibilities in respect of Shari‘ah compliance will inform its approach to inspection of these matters.

10.6.6 The supervisor may use independent experts (see TCP 2: Supervisor) to conduct part of an on-site inspection – for instance, when additional resources or specific expertise is needed.

10.6.7 The supervisor can conduct on-site inspections on either a broad or targeted basis. The purpose of a broad on-site inspection is to assess the overall condition, activities and risk profile of the TU. A targeted on-site inspection is focused on a specific area or areas of a TU, such as a particular key activity or process. Targeted on-site inspections can also be carried out across a number of TUs based on a specific theme, activity or risk (sometimes called “thematic reviews”). Targeted on-site inspections can be very effective in focusing supervisory resources quickly on those areas requiring immediate attention. If a targeted on-site inspection leads to other areas of supervisory concern, the supervisor may determine that a broad on-site inspection is necessary.

10.6.8 Advance notice is normally given to the TO before the supervisor conducts an on-site inspection so that both parties may plan accordingly. However,
the supervisor may decide not to provide advance notice in certain circumstances.

10.6.9 Examples of ways in which this standard and its corresponding guidance can be pursued include those set out in the Annex to this TCP.

Supervisory Feedback and Follow-Up

10.7 The supervisor discusses with the TO as soon as practical any relevant findings of the supervisory review and the need for any preventive or corrective measures.

10.7.1 The supervisor should provide appropriate feedback in a timely manner to the TO during the ongoing supervisory review process. The supervisor should issue in writing the findings of the review and the actions required. In many circumstances, the supervisor’s initial action will be to discuss the issue with the TO, which may resolve the issue and require no further action. However, some issues may require preventive or corrective measures – in some cases, imposing sanctions (see TCP 11: Preventive Measures, Corrective Measures and Sanctions).

10.7.2 Whether and how the TO has subsequently addressed issues identified by the supervisor should be considered in the evaluation of the TU and should be factored into the ongoing supervisory plan.

Annex: Examples of ways in which Standards 10.5 and 10.6 and their corresponding guidance can be pursued include the following:

A) The evaluation of the effectiveness of the TO’s Sharī`ah governance framework and corporate governance framework, including its risk management and internal control systems, can be done through:

- reviewing and analysing the minutes of the board and its committees;
- examining communications provided by the auditors to the board and/or the audit committee, such as the auditors’ reports;
- analysing information obtained from and/or received through direct engagement with the external auditor on substantial insights into the TO’s corporate governance framework, Sharī`ah governance, control environment and financial reporting;
- reviewing and analysing the minutes of the Sharī`ah board;
- examining communications provided by the Sharī`ah auditors to the Sharī`ah board, such as the Sharī`ah auditors’ reports;
- evaluating the suitability of significant owners by analysing the ownership structure and sources of finance/funding;
- evaluating the independence of the board members, the suitability of the board members, Sharī`ah board members, senior management and key persons in control functions, their effectiveness, and their ability to acknowledge improvement needs
and correct mistakes (especially after such needs or mistakes have been identified by the TO, its auditors, or the supervisor and after changes of management and in the board);
- testing the TO’s internal policies, processes and controls in order to assess compliance with regulations and/or adequacy of these in light of the TU’s risk profile;
- testing the accounting procedures in order to assess accuracy of the financial and statistical information periodically sent to the supervisor and its compliance with the regulations; and
- evaluating the organisational structure and the management of the TU.

B) Analyses of the nature of the TU’s activities can be done through:
- analysing business lines, the type of products offered, takāful participants and location of business;
- understanding the takāful operational framework, the contracts used, the organisation of the TU into funds (where this is practised), the business attributed to each fund and the charges made between funds;
- analysing the distribution model(s) used;
- meeting with the management to get information and a deeper understanding about current and future business plans;
- analysing material contracts;
- analysing the sales and marketing policies of the TO – in particular, policy conditions and remuneration paid to the intermediaries; and
- evaluating the retakāful cover and its security; in particular, the retakāful cover should be appropriate with regards to the financial means of the TU and the risks it covers.

C) Analyses of the relationships with external entities can be done through:
- analysing organisational charts, the group structures and the intra-group links;
- analysing the relationships with major investors and among branches and subsidiaries;
- analysing intra-group transactions, fees and other arrangements, including identifying instances of cross-subsidisation of businesses within a group or non-arm’s-length fees and charges;
- analysing agreements with external service providers;
- identifying financial problems originating from an entity in the group to which the TU belongs; and
- identifying conflicts of interest arising from intra-group relationships or relationships with external entities.

D) Evaluation of the TU’s financial condition can be done through:
- analysing the audited financial statements and off-balance sheet commitments;
- analysing the settlement of claims and calculation of technical provisions according to current regulations;
• analysing the investment policy and the assets held to cover the technical provisions;
• valuation of the TU’s investments;
• assessing litigation in which the TO is a party; and
• analysing the forecasted balance sheets and profit and loss accounts in relation to the most recent results and the management plans.

Where segregation of funds is practised, the above evaluations and analyses are performed for each material fund, and assessment at the fund level includes consideration of support mechanisms between funds.

E) Assessment of the TU’s fair treatment of customers can be done through:
• assessing the culture of the TO in relation to customer treatment, including the extent to which the TO’s leadership, governance, performance management and recruitment, complaints-handling policies and remuneration practices demonstrate a culture of fair treatment to customers;
• assessing how conflicts of interests with customers are identified, managed and mitigated;
• reviewing how products are designed and distributed to ensure they fulfil the customers’ demands and needs;
• checking the adequacy, appropriateness and timeliness of the information and advice given to customers;
• reviewing the handling and timing of claims and other payments;
• reviewing the handling, frequency and nature of customer complaints, disputes and litigation;
• reviewing any customer experience reports used by the TO or from other sources, such as an ombudsman;
• where segregation of funds is practised, assessing the fairness of charges made between funds, and the attribution of revenues and expenses to different funds; and
• where distribution of surplus to takāful participants is practised, assessing the basis of determination of surplus and of distribution.

TCP 11: PREVENTIVE MEASURES, CORRECTIVE MEASURES AND SANCTIONS
The supervisor:
• requires and enforces preventive and corrective measures; and
• imposes sanctions

which are timely, necessary to achieve the objectives of takāful supervision, and based on clear, objective, consistent and publicly disclosed general criteria.

Introductory Guidance
11.0.1 The supervisor should initiate escalating measures to prevent a breach of regulatory requirements by a TO, to respond to a breach of regulatory requirements by a TO, and to enforce those measures to ensure that the TO responds to the supervisor’s concerns. Preventive measures should be used to prevent a breach of regulatory requirements, and corrective measures should be used to respond to a breach of regulatory requirements. Functionally, supervisors may take similar or identical actions as preventive or corrective measures. In addition, where a regulatory requirement has been violated, supervisors may use sanctions.

11.0.2 The supervisor should promptly and effectively deal with TU non-compliance with regulatory requirements or supervisory measures that could put policyholders at risk, could pose a threat to financial stability, or could impinge on any other supervisory objectives. The more significant the threat to takāful participants’ interests or to financial stability, then the sooner the supervisor will need to act and to require action from the TO, and the more significant the measures that may be required. By mitigating certain risks, preventive and corrective measures that are primarily intended to protect takāful participants may also contribute to financial stability, by decreasing the probability and magnitude of any negative systemic impact.

11.0.3 The supervisor should also require the TO to address promptly and effectively any Sharī‘ah non-compliance which may, in the supervisor’s view, pose a threat to public confidence in the validity of the TO’s claims to be operating and entering into contracts with takāful participants in compliance with Sharī‘ah.

11.0.4 Circumstances may arise when preventive or corrective measures are insufficient to prevent a TU from being no longer viable, or likely to become no longer viable, and therefore need to exit the market or be resolved (see TCP 12: Exit from the Market and Resolution).

11.0.5 As part of the supervisory framework (see TCP 10: Supervisory Review and Reporting), the supervisor should consider in advance how to use preventive and corrective measures, enforcement of those measures, and the imposition of sanctions. A supervisor’s framework should be documented to assist in the delivery of consistent supervision over time. It is crucial that the framework leaves room for the exercise of supervisory judgment and discretion, so flexibility should be allowed in the use of preventive measures, corrective measures and sanctions. In addition to general criteria, other parts of the framework on preventive measures, corrective measures and sanctions can also be released publicly, particularly where the supervisor feels that this additional transparency will lead to the market functioning more effectively. The decision-making processes that underpin the supervisory framework should function in a way that allows the supervisor to take immediate action when necessary.

11.0.6 In some instances, the supervisor will need to work with other authorities or bodies in order to take or enforce supervisory measures or sanctions.
against a TU. For example, some measures or sanctions will require the approval of a judicial body.

11.0.7 There are different methods by which supervisory outcomes can be achieved. The method chosen may vary depending on the jurisdiction’s legal framework. In some jurisdictions, one method is to accept an enforceable written agreement to do, or not to do, some thing or things from the TO in question. The potential advantages of achieving an outcome by this route are that it can be quicker and less costly. This option can be used to achieve outcomes related to preventive or corrective measures or to sanctions.

Group Perspectives

11.0.8 Measures or sanctions targeted at a non-takāful and non-insurance legal entity within an insurance group may require the supervisor to work with other regulatory authorities.

11.0.9 The supervisor for a TU within an insurance group should inform other involved takāful or conventional insurance supervisors when taking supervisory measures against or imposing sanctions on that TU, where those sanctions are material or otherwise relevant to those supervisors.

11.1 The supervisor acts against individuals or entities that conduct takāful activities without the necessary licence.

11.1.1 The supervisor should have in place mechanisms to identify when unlicensed takāful activity is being carried out. Examples of such mechanisms include monitoring of media and advertising, review of consumer complaints or encouraging industry and other stakeholders to notify the supervisor of suspicious activity.

11.1.2 Where unlicensed activity is identified, the supervisor should act to address the issue. Examples include requiring the unlicensed entity to apply for a licence, seeking court orders to require the unlicensed entity to stop the activity, informing law enforcement authorities of criminal and/or civil concerns, imposing sanctions on the individual/entity, or publicising the fact that the individual and/or entity is/are not licensed to conduct takāful activities.

11.2 The supervisor requires preventive measures if the TO seems likely to operate in a manner that is inconsistent with regulatory requirements.

11.2.1 Determining when a TO seems likely to operate in a manner that is inconsistent with regulatory requirements will require a degree of discretion on the part of the supervisor. Nevertheless, concerns that necessitate preventive measures should be well founded based on the supervisor’s assessment.
11.2.2 If the TO operates in a manner that is likely to impact its ability to protect policyholders’ interests or to pose a threat to financial stability, the supervisor should act more urgently in requiring preventive measures.

11.2.3 The supervisor should communicate concerns to the TO with a promptness that reflects the significance of the concern. Some concerns, such as relating to TU solvency, takāful participant protection or financial stability, will be sufficiently significant to require immediate communication to the TO. Other concerns, although significant, may not require such rapid communication, but should still be communicated appropriately. For example, it is unlikely to be appropriate for a supervisor to wait for the next on-site visit to a TO before communicating a significant concern.

11.2.4 The supervisor should promptly bring significant concerns to the attention of the board because it has ultimate responsibility for the TO and that such concerns are resolved. In addition, the supervisor should communicate with senior management and with key persons in control functions to bring significant concerns to their attention.

11.2.5 The supervisor should have available a range of preventive measures broad enough to address TUs of all sizes and complexities. Preventive measures should be chosen to address the severity of the TU’s problems.

11.2.6 The supervisor should have the power to issue and enforce:

- restrictions on business activities, such as:
  - prohibiting the TU from issuing new takāful contracts or new types of product;
  - requiring the TU to alter its sales practices or other business practices;
  - withholding approval for new business activities or acquisitions;
  - restricting the transfer of assets;
  - prohibiting the TO from continuing a business relationship with an intermediary or other outsourced provider, or requiring the terms of such a relationship to be varied;
  - restricting the ownership of subsidiaries; and
  - restricting activities of a subsidiary where, in its opinion, such activities jeopardise the financial situation of the TU;

- directions to reinforce the TU’s financial position, such as:
  - requiring measures that reduce or mitigate risks (e.g. restricting exposures, through either hard or soft limits, to individual counterparties, sectors or asset classes);
  - requiring an increase in capital;
  - restricting or suspending dividend or other payments to shareholders; and
  - restricting purchase of the TU’s own shares; and

- other directions, including:
requiring the reinforcement of governance arrangements, internal controls or the risk management system;
requiring the TO to prepare a report describing actions it intends to undertake to address specific activities the supervisor has identified, through macroprudential surveillance, as potentially posing a threat to financial stability (see TCP 24: Macroprudential Supervision);
facilitating the transfer of obligations under the takāful contracts from a failing TU to another TU that accepts this transfer;
suspending the licence of a TO; and
barring individuals acting in key roles from such roles in future.

11.2.7 Where segregation of funds is practised, the supervisor's powers should include the ability to issue and enforce directions to be applied at the level of each fund making up the takāful legal entity, including:
• restricting or prohibiting the attribution of specified income or expense items to the fund, or directing attribution of those items to a different fund or funds;
• requiring the TO to undertake action to mitigate specified risks at the level of a fund;
• restricting or prohibiting the acceptance of new takāful business into a fund;
• where, as a condition of recognising qard as capital resources, the TO has agreed to subordinate qard or a qard facility, restricting or prohibiting the repayment of qard from a fund, requiring qard (or further qard) to be paid into the fund, or requiring qard owed by the fund to be converted into a gift;
• requiring all or part of surplus in a fund to be retained within the fund (notwithstanding any contractual obligation or discretion to apply it otherwise);
• restricting or prohibiting the transfer of assets from a PRF or PIF to the SHF; and
• facilitating the transfer of the management of a PRF or PIF to another TO.

11.2.8 The supervisor may also have other powers available, including:
• temporarily delaying or suspending, in whole or in part, the payments of the redemption values on takāful liabilities or payments of advances on contracts;
• lowering the maximum rate of guarantees for new business or introducing additional reserving requirements; or
• incentivising the use of a system-wide lending facility, when available, for market-wide liquidity issues extending to TUs.

TCP 17 discusses the role of the lender's agreement to subordination, in making qard or a qard facility potentially eligible as capital resources.
11.2.9 The supervisor should, where practicable and compatible with its supervisory objectives, exercise its enforcement powers over TOs in a manner that does not cause the TOs concerned to cease to comply with Shari’ah rules and principles.

11.2.10 The supervisor should take steps to address problems arising from board members, senior management, key persons in control functions, significant owners, external auditors and any other person who plays a significant role within the TO. For example, the supervisor should require the TO to replace or restrict the power and role of those involved (listed above) in the governance processes if the supervisor has material concerns with management or governance.

11.2.11 The supervisor should reject, rescind and/or request a court to revoke the appointment of an external auditor who is deemed to have inadequate expertise or independence, or is not subject to, or does not adhere to, established professional standards.

11.2.12 Supervisors should take action to address TO audit quality concerns, including, where possible, requiring replacement or appointment of a supplementary auditor and the sanctioning of an external auditor if necessary. Supervisors should watch for indicators of potential major audit quality concerns, such as when:
• the auditor does not have adequate takāful industry knowledge and competence;
• there is an identified issue with auditor objectivity and independence;
• the auditor does not disclose to the supervisor matters that it is required to disclose;
• clear audit quality concerns are identified, such as if the auditor fails to test internal control systems sufficiently, the auditor is not appropriately sceptical, or does not appropriately challenge the TO’s management regarding the major accounting figures; or
• the auditor’s system of internal quality control appears ineffective.

11.3 The supervisor requires corrective measures if the TU fails to operate in a manner that is consistent with regulatory requirements.

11.3.1 The guidance under Standard 11.2 is equally applicable when considering corrective measures.

11.3.2 In addition to the supervisory tools set out in Guidance paragraphs 11.2.6 and 11.2.7, when considering corrective measures the supervisor may find it necessary, in cases of serious breach of regulatory requirements, to revoke the licence of a TU. The supervisor should be able to enforce this decision.

11.4 The supervisor:
• requires the TO to take actions that address the supervisor's identified concerns;
• periodically checks that the TO is taking action; and
assesses the effectiveness of the TO’s actions.

11.4.1 The supervisor should require the TO to prepare a plan to resolve the concerns within an acceptable time frame. The plan should include actions proposed by the TO or preventive or corrective measures required by the supervisor. What is acceptable as a time frame will depend on the circumstances of the concerns raised.

11.4.2 If the TO does not prepare an acceptable plan in a specified time frame to respond to the supervisor’s concerns, the supervisor should impose such a plan on the TO.

11.4.3 The supervisor should review the results of the actions that the TU has taken. The supervisor should review both whether the actions have been taken and, if so, the effectiveness of the actions.

11.4.4 The supervisor may require assurance from an independent reviewer regarding adequate resolution of significant concerns. In such cases the supervisor may also require that such an independent reviewer be appointed at the expense of the TU.

11.5 The supervisor escalates, including enforcing, preventive or corrective measures if its concerns are not addressed by the TO’s actions.

11.5.1 The supervisor should require further measures if its concerns with the TU become worse, including if the TO fails to take the actions in a plan.

11.5.2 Supervisory measures should escalate in line with the supervisor’s concerns about the TU. If the TO’s inaction leads to an increased risk to takāful participants, then the supervisor should respond by requiring stronger measures to mitigate this risk.

11.5.3 Enforcement of preventive or corrective measures could involve the supervisor issuing a formal direction to a TO to take particular actions or to cease conducting particular activities. It could also involve the supervisor seeking the assistance of other authorities, or the courts, to enforce a measure.

11.6 The supervisor imposes sanctions on TUs and individuals proportionate to the breach of regulatory requirements or other misconduct.

11.6.1 The supervisor should be able to impose a range of sanctions, which could be administrative, civil or criminal in nature. These can include the ability to impose fines, the ability to bar individuals acting in key roles from holding similar roles in future, and the ability to require remediation (such as requiring compensation of takāful participants in cases of mis-selling). It is recognised that supervisors will not always be able to take a full range of legally binding actions themselves and may need to act in conjunction with,
or refer matters to, other authorities – in particular, in the case of criminal penalties.

11.6.2 In some cases it may be appropriate to apply sanctions against TOs or individuals when justified by their actions or inactions.

11.6.3 The supervisor should, in particular, be able to impose sanctions against TOs and individuals who:

- fail to provide information to the supervisor in a timely fashion;
- withhold information from the supervisor;
- provide information that is intended to mislead the supervisor;
- deliberately misreport to the supervisor; or
- do not act in accordance with orders or directions imposed on the TO.

11.6.4 The sanctions imposed by the supervisor should be commensurate with the nature and severity of the TU's non-compliance with regulatory requirements. Administrative or procedural breaches will generally attract less severe sanctions than breaches arising from a TO's intentional disregard of regulatory requirements. The sanction imposed should be sufficiently dissuasive so that the TO does not, or other TOs do not, commit a similar breach in the future.

11.6.5 The supervisor should impose more severe sanctions relative to the gravity of the breach where a TO's history demonstrates a pattern of non-compliance with regulatory requirements.

11.6.6 The supervisor may impose sanctions on TOs or individuals in addition to supervisory measures or in the absence of supervisory measures.

11.6.7 The imposition of sanctions against a TO or an individual typically should not delay either supervisory measures or action by a TO taken in response to supervisory measures. However, in some instances, the nature of the sanctions may delay supervisory measures. For example, where a supervisor sanctions a TO by requiring a number of senior managers to be replaced with new individuals, supervisory measures intended to improve the governance of the TO may not be practical until after the new individuals are appointed.

11.6.8 The supervisor, or another responsible authority in the jurisdiction, should take action to enforce sanctions that have been imposed.

11.6.9 The supervisor should sanction TOs and individuals within a consistent framework, so that similar violations and weaknesses attract similar sanctions. Supervisors should consider how proposed sanctions relate to previous cases. The supervisor should identify precedents where the supervisor has sanctioned a TO or individual for similar actions/inactions. Where the supervisor has sanctioned a TO or individual for similar actions/inactions, then the supervisor should consider carefully whether a comparable sanction is appropriate. If the supervisor concludes that a very
different sanction is appropriate, the supervisor should be prepared to explain why it reached this conclusion.

11.6.10 In order for sanctions to have a deterrent effect on other TOs, the fact of the sanction, and sufficient details of the breach, should in general be published. However, the supervisor should retain the discretion to take a different course of action (e.g. not to publish, or to delay publication) where this would further the achievement of supervisory objectives or it is otherwise in the public interest to do so.

TCP 12: EXIT FROM THE MARKET AND RESOLUTION

Legislation provides requirements for:
- the voluntary exit of TUs or TOs from the market; and
- the resolution of TUs that are no longer viable or are likely to be no longer viable, and have no reasonable prospect of returning to viability.

Introductory Guidance

12.0.1 An orderly process for withdrawal from the business of takāful helps to protect takāful participants, and contributes to the stability of the takāful market and the financial system. Jurisdictions should have transparent and effective regimes for a TU’s or a TO’s exit from the market and the resolution of a TU.

12.0.2 In the context of takāful operated on a segregation of funds basis, more than one exit or resolution scenario is possible. A TO may wish or be compelled to exit the industry, but with its funds continuing to operate under management of a different TO. Voluntary discontinuance of a fund is also possible, while other funds managed by the same TO continue in operation. It is also possible that a fund could be placed involuntarily into resolution (in the sense described in the following paragraph) while the TO continues to operate other funds. Where windows operate, the window as a whole or a fund within the window may need to be considered. The exit and resolution regime needs to cater for action at the level of the fund as well as at that of the legal entity.

12.0.3 In this TCP, “resolution” refers to an action taken by a resolution authority towards a TU that is no longer viable, or is likely to be no longer viable, and has no reasonable prospect of returning to viability.

12.0.4 In this TCP, the term “resolution authority” refers to authorities that are responsible for exercising resolution powers over TUs. Depending on the jurisdiction, this term may include supervisors, other governmental entities or private persons (including administrators, receivers, trustees, conservators, liquidators, or other officers), or courts authorised by law to exercise resolution powers. Thus in this TCP:
- “supervisor” is used when the standard and/or guidance involves responsibilities and/or roles of the day-to-day supervisor of the TU;
• “resolution authority” is used when the standard and/or guidance involves resolution powers and/or processes after resolution has been instituted: this includes supervisors acting under their resolution powers; and
• “supervisor and/or resolution authority” is used when the standard and/or guidance involves responsibilities for planning and/or initiation of resolution and encompasses supervisors acting in their pre-resolution roles (e.g. before a supervisor or resolution authority institutes resolution and/or obtains any necessary administrative and/or judicial approvals to do so).

12.0.5 The structure and roles of resolution authorities vary across jurisdictions. In some jurisdictions, the resolution authority and the supervisor may be one single authority; in other jurisdictions, resolution of TUs may be the responsibility of one or more separate authorities. In some jurisdictions certain resolution powers may be exercised or overseen by the court. Whatever the allocation of responsibilities, a transparent and effective resolution regime should clearly delineate the responsibilities and powers of each authority involved in the resolution of TUs (see TCP 1: Objectives, Powers and Responsibilities of the Supervisor). Where there are multiple authorities responsible for the resolution of TUs, the resolution regime should empower the relevant authorities to cooperate and coordinate with each other.

12.0.6 “Exit from the market” refers to cessation of the TU’s business, in part or in whole. TOs of TUs that meet regulatory requirements may decide to exit from the market on a voluntary basis for business and/or strategic reasons. This is often referred to as “voluntary exit from the market”.

12.0.7 TOs or TUs may also be required by the supervisor to exit from the market. For example, supervisory measures and/or sanctions may result in a TU exiting from the market (i.e. involuntary exit from the market) (see TCP 11: Preventive Measures, Corrective Measures and Sanctions).

12.0.8 Jurisdictions may need to have mechanisms in place to determine whether the continuity of takāful cover is necessary when TUs exit from the market. Any such continuity should preferably be on the same contract terms, but when necessary, on amended terms. Such mechanisms need to be proportionate to the unique nature and structure of the takāful market in each jurisdiction. Continuity of takāful cover may be facilitated by transferring takāful portfolios to a succeeding TO for management, including a bridge institution. Continuity of some takāful contracts, particularly for some general takāful products, may be necessary for only a short period (e.g. 30 or 60 days) so that the takāful participant has sufficient time to find another TU to provide replacement cover. Facilitating continuity of takāful cover might not be necessary for certain types of takāful products, such as those that are offered by many TOs in a market and which are highly substitutable.
12.0.9 Where a TU exits from the market and there is no succeeding TO to assume management of the portfolio or no similar takāful products available in the market, mechanisms that facilitate the availability of alternative cover may need to be explored by the supervisor, such as when the exiting TU delivers takāful contracts that cover risks that may be important to a particular jurisdiction’s economy and/or are compulsory takāful in legislation.

12.0.10 TUs or segments of TUs that are no longer viable or likely to be no longer viable, and which have no reasonable prospect of becoming so through their recovery action or supervisory measures, should be resolved. Figure 12.1 illustrates in a stylised way the relationship between solvency, viability and the nature of actions to be taken. No uniform, single fixed point of non-viability can be defined that will be appropriate for the application of resolution measures in all circumstances. This is all the more the case where viability needs to be assessed at the level of the fund. Whether to apply resolution measures, and the type of measures implemented, will depend upon the factual circumstances of the particular resolution scenario.

**Figure 12.1 Relationship between solvency, viability and actions to be taken**

![Graph showing relationship between solvency, viability and actions to be taken]

12.0.11 A resolution regime should make it possible for any losses to be absorbed in a manner that respects the jurisdiction’s liquidation claims hierarchy, but also according to the principle that the entitlements of takāful participants and other beneficiaries under takāful contracts should absorb losses only after, first, all capital resources recognised for solvency purposes (including any attributable to takāful participants) and, second, all lower-ranking creditors have absorbed losses to the full extent of their claims. Mechanisms such as policyholder protection schemes (PPSs) may mitigate the need for the absorption of losses by takāful participants and other beneficiaries under takāful contracts.

12.0.12 Capital resources in Guidance paragraph 12.0.11 include contributed capital and retained surpluses in accordance with TCP 17: *Capital Adequacy*. Where segregation of funds is practised, the relevant capital resources within or with respect to a fund should include any surpluses
retained within the fund, any amounts gifted to the fund, and any qard paid in or pledged to the fund that ranks behind entitlements of takāful participants and other beneficiaries under takāful contracts in the event of winding-up, and meets other conditions for recognition as capital resources (see TCP 17).

12.0.13 Depending on the circumstances, appropriate resolution measures may be applied to one or more separate entities in an insurance group, such as: (i) the head of the insurance group; (ii) an intermediate holding company below the head of the insurance group; (iii) a TU within the group; (iv) a branch of a TU within the group; or (v) other regulated (e.g. banks) or non-regulated entities within the group. For other regulated entities within the group (e.g. banks), a resolution regime relevant to their sector may apply.

12.0.14 Some TOs operate TUs on a cross-border basis through subsidiaries or branches in another jurisdiction, or through providing takāful services on a cross-border basis without setting up a physical presence outside their home jurisdiction. Also, where a TU is a member of a group, there could be intra-group transactions and guarantees among TUs and/or other group entities in different jurisdictions. Cross-border coordination and cooperation, including exchange of information, is necessary for the orderly and effective resolution of TUs that are operated on a cross-border basis.

Voluntary Exit from the Market

12.1 Legislation provides a framework for voluntary exit from the market that protects the interests of takāful participants.

12.1.1 Voluntary exit from the market is initiated by the TO.

12.1.2 Where the TO is required to consult, or to obtain the approval of the takāful participants prior to exit from the market, or closure of a takāful fund, the TO must ensure that the process for consulting or seeking approval from takāful participants is subject to appropriate independent oversight intended to ensure that information provided to the takāful participants is clear, fair and not misleading, and that takāful participants have the opportunity to make an informed decision and communicate that decision to the TO. The process of collection of communications, counting and determination of the result should also be subject to appropriate independent oversight.

12.1.3 The supervisor should require the TO which voluntarily exits from the market to make appropriate arrangements for the voluntary exit (e.g. run-off or portfolio transfer), including ensuring adequate human and financial resources to fulfil all its takāful obligations.

12.1.4 The supervisor should require the TO which voluntarily exits from the market through run-off, whether for the whole of its business or (where operation is by segregated funds) for one or more of the funds managed
by it, to submit a run-off programme to the supervisor for the part of its business that is to be discontinued.

The programme should include at least the following information:

- expected time frame;
- projected financial statements;
- human and material resources that will be available;
- governance and risk management of the process;
- Shari’ah governance of the process;
- communication with takāful participants about the TO’s exit from the market, or cessation of operation of the fund, as the case may be; and
- communication to the public.

12.1.5 TOs that exit from the market on a voluntary basis should continue to be subject to supervision until all takāful obligations are either discharged or transferred to another TO. Similarly, a fund placed into run-off by the TO should remain subject to supervisory requirements at fund level. Legislation should provide for appropriate requirements for these exiting TOs and closing funds.

Objectives of the Resolution of TUs

12.2 Legislation provides a framework for resolving TUs which:

- protects takāful participants; and
- provides for the absorption of losses in a manner that respects the liquidation claims hierarchy.

12.2.1 The legislation should support the objective of protecting takāful participants. This, however, does not mean that takāful participants will be fully protected under all circumstances and does not exclude the possibility that losses will be absorbed by takāful participants, to the extent they are not covered by PPSs or other mechanisms. A jurisdiction may have additional resolution objectives in the legislation, such as contributing to financial stability.

12.2.2 The legislation should provide a scheme for prioritising the payment of claims of takāful participants and other creditors in liquidation (liquidation claims hierarchy). Resolution powers should be exercised in a way that respects the hierarchy of creditors’ claims in liquidation. In a resolution action other than a liquidation, creditors should be entitled to compensation if they receive less than they would have received if the TU was liquidated (i.e. the “no creditor worse off than in liquidation” [NCWOL] principle). The NCWOL principle may require funding to provide compensation to creditors so that they receive at least as much as they would have received in a liquidation.

12.2.3 Resolution should seek to minimise reliance on public funding. In principle, any public funding used for the resolution of the TU should be recouped from the takāful sector in a transparent manner. The phrase “reliance on
public funding” does not refer to the use of funds from PPSs to support the implementation of resolution actions.

Sharī`ah Governance in Resolution

12.3 The resolution process has regard to matters relating to Sharī`ah compliance and includes the obtaining of advice where necessary.

12.3.1 Questions of Sharī`ah compliance may arise in the resolution process of a TU or of a fund, in respect of actions to be taken by the TO or by the designated resolution authority.

12.3.2 The interests of takāful participants in a resolution include their interest in the Sharī`ah compliance of contracts in which they have engaged, and in the performance of those contracts.

12.3.3 The TO maintains a Sharī`ah governance function during the resolution process to advise the board or other person (e.g. liquidator, inspector, administrator) charged with managing the affairs of the TU. TCP 8 on Sharī`ah governance provides standards on the Sharī`ah governance function.

12.3.4 Where the board or other person charged with managing the affairs of the TU becomes aware of an issue regarding Sharī`ah compliance in the resolution process, the board should seek to understand the issue and consider whether their legal obligations can be applied in a manner that respects Sharī`ah compliance while also protecting the interests of takāful participants.

12.3.5 The supervisor or the designated resolution authority may have responsibility for enforcement of Sharī`ah compliance, though in many jurisdictions this is not the case. However, even where the supervisor or the designated resolution authority does not have this responsibility, the express or implied contractual right of takāful participants to Sharī`ah compliance in their dealings with the TO is a relevant consideration for the supervisor or designated resolution authority.

12.3.6 The designated resolution authority or authorities may have their own Sharī`ah governance function. Where this is not the case, then in the event that matters relating to Sharī`ah compliance are brought to the attention of the authority concerned, it should have access to advice on Sharī`ah, independent of the TO under resolution.

12.3.7 Where questions arise on the permissibility under Sharī`ah of proposed resolution actions to be taken by, at the direction of or under the authority of the resolution authority, the authority should seek to understand the issue concerned, and consider whether the legislation can be applied in a manner that respects expressed concerns as to Sharī`ah compliance while also protecting the interests of takāful participants.
Planning

12.4 The supervisor and/or the resolution authority requires, as necessary, TOs to evaluate prospectively their specific operations and risks in possible resolution scenarios and to put in place procedures for use during a resolution.

12.4.1 The supervisor may identify risks, specific to a TU’s circumstances, that would arise in resolution and which may impact achieving the resolution objectives of the jurisdiction. For example, such risks may relate to the TO’s provision of relevant information to the supervisor or resolution authority, the continuity of certain business operations, and/or the orderly implementation of a jurisdiction’s PPS.

12.4.2 The supervisor should require the TO to consider such risks and, where appropriate, prepare contingency plans to mitigate the risk.

12.4.3 The supervisor should require that the TO have procedures in place to provide necessary information (e.g. takāful participants’ names, types of contracts, and the value of each contract) to a relevant organisation (such as a PPS) in a timely manner when the TU enters into resolution.

12.4.4 In the TO’s own contingency planning for foreseeable resolution scenarios, it should also consider whether the resolution mechanisms available if the need arises carry implications for Shari‘ah compliance. The TO’s Shari‘ah governance function should therefore be consulted when the plan is developed, and review the TO’s resolution plan before it is adopted by the board, in order to identify potential concerns relating to Shari‘ah compliance, or matters in the foreseeable resolution scenarios where current understanding of Shari‘ah lacks precedents on which to draw. This process enables any necessary (albeit precautionary) deliberation by the Shari‘ah board to take place in advance of the scenario occurring, rather than as an emergency in the teeth of a crisis. For example, if a resolution response would be to seek the merger of all or part of the TU with another TU applying a different takāful operating model, the Shari‘ah implications of such a mechanism should be first considered when the plan is put in place, not when it is implemented. The Shari‘ah governance function may advise the TO that a particular resolution action carries a high risk of Shari‘ah non-compliance, or recommend modification to the action in order to mitigate the risk.

Cooperation and Coordination

12.5 The roles and responsibilities of relevant authorities within a jurisdiction that are involved in the exit of TUs from the market or their resolution are clearly defined.

12.5.1 The jurisdiction should have a designated authority or authorities empowered to exercise powers for the resolution of a TU. Where there are multiple authorities within a jurisdiction, their respective mandates, roles and responsibilities are clearly defined and coordinated.
12.5.2 Where different authorities within a single jurisdiction are in charge of the resolution of a TU, a lead authority that coordinates the resolution of the TU should be identified.

12.5.3 An example where a lead resolution authority should be identified is where the TU has takāful and other financial operations (such as banking), and the authority responsible for the resolution of the other financial operations is different from the authority responsible for the resolution of the takāful operations in the jurisdiction.

12.5.4 Coordination agreements may be established where multiple authorities may be involved in the resolution of a TU.

12.6 The supervisor and/or resolution authority shares information, cooperates and coordinates with other relevant authorities for the exit of TUs from the market or their resolution.

12.6.1 Relevant authorities in this context may include the group-wide supervisor and/or resolution authority, other involved supervisors and/or resolution authorities, and others that may need to be involved in the resolution of TUs, such as PPS and supervisors in other financial sectors.

12.6.2 When a TU voluntarily exits from the market, the supervisor should cooperate and coordinate with other relevant supervisors as necessary.

12.6.3 Cooperation and coordination should include matters, among others, such as consulting with or informing other relevant authorities of, for example, the anticipated exercise of resolution powers that the resolution authority considers necessary before taking resolution actions, where this is practicable.

12.6.4 When consulting, authorities should seek to determine if coordinated action on the resolution of an insurance group is necessary to avoid or minimise the adverse impact on other group entities.

12.6.5 The supervisor and/or resolution authority should seek to achieve a cooperative solution with authorities in other jurisdictions who are concerned with the resolution of the insurance group.

12.6.6 Cooperation and coordination would be crucial when considering resolution action such as ordering the TU to cease business (e.g. when the TU has overseas branches), freezing the TU's assets, and/or removing management of overseas branches, subsidiaries or holding companies.

12.6.7 Information sharing, cooperation and coordination should be undertaken in a manner that does not compromise the prospect of successful exit or resolution.

12.6.8 Cross-border coordination agreements may need to be established between relevant authorities.
Triggers

12.7 Legislation provides criteria for determining the circumstances in which the supervisor and/or resolution authority initiates resolution of a TU.

12.7.1 Resolution should be initiated where a TU is no longer viable, or is likely to be no longer viable and has no reasonable prospect of becoming so, even if the entity is solvent in light of financial reporting standards. Criteria that determine or help to determine when the supervisor and/or resolution authority initiates resolution should be considered in light of the TU and the circumstances of its resolution. Criteria for determining whether resolution processes should be initiated may include:

- the TU is in breach of the minimum capital requirement (MCR) and there is no reasonable prospect of restoring compliance with the MCR;
- the consolidated own funds of the insurance group are lower than the sum of the proportional shares of the MCRs of the regulated legal entities belonging to the insurance group (e.g. due to double-gearing);
- the TU is in breach of other material prudential requirements (such as a requirement on assets backing technical provisions) and there is no reasonable prospect of compliance being restored;
- there is a strong likelihood that takāful participants and/or other creditors will not receive payments as they fall due;
- intra-group transactions impede, or are likely to impede, the ability of the TU to meet takāful participants and/or creditor obligations as they fall due; or
- measures attempting the recovery of the TUs have failed, or there is a strong likelihood that such proposed measures will: (i) not be sufficient to return the TU to viability; or (ii) cannot be implemented in a reasonable time frame.

12.7.2 Where segregation is practised between takāful funds and shareholders’ funds, triggers referred to in the foregoing paragraph may also be applied at the level of the fund, whereby a particular fund is identified as no longer viable and having no reasonable prospect of becoming so. The viability of a fund should be considered both before and taking account of qarḍ advanced or any commitment to provide qarḍ. The presence of a fund with persistent deficiency, such that the fund is dependent upon qarḍ to enable it to meet its obligations to takāful participants and other creditors, may indicate that the fund is non-viable and requires resolution, particularly if future deficits continue to accrete. Whether a requirement for resolution of the fund should also trigger resolution of the TU as a whole may depend upon whether the fund can be run off in a solvent manner.

Powers

12.8 Legislation provides an appropriate range of powers to resolve TUs effectively. These powers are exercised proportionately and with appropriate flexibility.
12.8.1 Powers to resolve TUs should be exercised in a proportionate manner that resolves the TU most effectively in light of the circumstances and objectives of resolution. Some powers may not be needed for all TUs but only for TUs that are, for example, of systemic importance in the jurisdiction. Some powers may only affect the TU, while others may impact contractual rights of third parties (such as a suspension of takāful participants’ rights or restructuring of takāful contracts).

12.8.2 Some resolution powers are exercised with the aim to stabilise or restructure a TU and avoid liquidation. Liquidation can be used in conjunction with other resolution powers. Creditors should have a right to compensation where they do not receive at a minimum what they would have received in a liquidation of the TU under the applicable insolvency regime (NCWOL principle).

12.8.3 If a court order is required for the resolution authority to exercise resolution powers, the time required for court proceedings should be taken into consideration for the effective implementation of resolution actions.

12.8.4 Powers to resolve TUs that may be exercised, subject to adequate safeguards, should include those listed below. (This list is not exhaustive and the resolution authority should have discretion to apply other available powers. The order of presentation of the powers is not an indication of the sequence in which these powers could be exercised.) The powers are to:

- prohibit the payment of dividends to shareholders;
- prohibit the distribution or transfer of surplus from takāful funds;
- prohibit the repayment of subordinated qard from takāful funds until all entitlements of takāful participants and beneficiaries relating to the fund have been met;
- require the payment of subordinated qard, or qard facility, to takāful funds;
- prohibit the payment of variable remuneration to, and allow the recovery of monies from, members of the board, members of the Shari‘ah board, senior management, key persons in control functions and major risk-taking staff, including claw-back of variable remuneration;
- prohibit the transfer of the TU’s assets without supervisory approval;
- retain, remove or replace the board, Shari‘ah board, senior management and key persons in control functions;
- take control of and manage the TU, or appoint an administrator or manager to do so;
- withdraw the licence to write new business and put all or part of the takāful business contracts into run-off;
- sell or transfer the shares of the TO to a third party;
- restructure, limit or write down liabilities (including takāful liabilities and amounts of qard due from takāful funds), and allocate losses to qard, other creditors and takāful participants, where applicable and in a
manner consistent with the liquidation claims hierarchy and jurisdiction’s legal framework; 13
• override rights of shareholders of the TO in resolution (and, where applicable, rights of takāful participants), including requirements for approval by shareholders and, if applicable, takāful participants of particular transactions, in order to permit a merger, acquisition, sale of substantial business operations, recapitalisation or other measures to restructure and dispose of the TU’s business or its liabilities and assets;
• terminate, continue or transfer certain types of contracts, including takāful contracts;
• transfer or sell the whole or part of the assets and liabilities of the TU to a solvent TU or third party in a manner compliant with Sharī`ah;
• transfer any retakāful and/or conventional reinsurance associated with transferred takāful contracts without the consent of the retakāful provider or conventional reinsurer;
• temporarily restrict or suspend the takāful participants’ rights of withdrawing their takāful contracts;
• stay rights of the retakāful providers and/or conventional reinsurers of the ceding TU in resolution to terminate or not reinstate coverage relating to periods after the commencement of resolution;
• impose a temporary suspension of payments to unsecured creditors and stay on creditor actions to attach assets or otherwise collect money or property from the TU; and
• initiate the liquidation of the whole or part of the TU.

12.8.5 The choice and application of the powers set out above should take into account whether a TU’s disorderly failure would potentially cause significant disruption to the financial system and real economy, the types of business the TU is engaged in, and the nature of its assets and liabilities.

12.8.6 Where the resolution authority takes action which leads to another person taking control of a TU with a view to restoring, restructuring or running off the business, the resolution authority should continue to be responsible for the orderly resolution of the TU. In particular, the resolution authority should continue to exercise functions which ensure that the objectives of resolution are met, notwithstanding any additional responsibilities which the person appointed may have to the TU or to the courts.

12.8.7 Resolution powers should be exercised in a manner that does not discriminate between creditors on the basis of their nationality, the location of their claim, or the jurisdiction where it is payable.

13 The IFSB Shari’ah Board is of the view that the creditor hierarchy from the Shari’ah perspective places qard ahead of takāful participant claims, except where the creditor has explicitly agreed to subordination of the qard.
Mechanisms should be in place to: (i) enable continuity of cover for takāful participants where this is needed; and (ii) ensure timely payment of claims to takāful participants of the TU in resolution, with the aim to minimise disruption to the timely provision of benefits to takāful participants. A PPS can be one of the mechanisms that can help ensure timely payments to takāful participants and minimise disruption.

When requiring contracts to be transferred to another TU, the resolution authority should satisfy itself that the interests of the takāful participants of the transferor and of the transferee are safeguarded. In some cases, this may be achieved through varying, reducing or restructuring the transferred liabilities.

Portfolio transfers and transfers of other types of contracts of the TU in resolution should not require the consent of each takāful participant or party to the contract.

Consistent with the liquidation claims hierarchy, takāful liabilities should be written down only after equity and all liabilities that rank lower than takāful liabilities have absorbed losses, and only if the resolution authority is satisfied that takāful participants are no worse off than in liquidation after compensation, where necessary.

Information on the period during which takāful participants are prohibited from withdrawing from their takāful contracts should be available to takāful participants in a transparent manner for the purposes of takāful participant protection.

The exercise of stay powers, their scope of application and the duration of the stays should be designed to address the specific situation of the TU in resolution. For example, the duration of the stay could depend on the type of takāful or financial contract.

Group and Branch Perspectives

There may be circumstances where resolution powers will need to be exercised at the level of the head of the insurance group and/or non-regulated entities. Resolution authorities should have the capacity to exercise resolution powers directly on such entities within their jurisdiction to the extent necessary and appropriate. Where resolution powers need to be exercised on entities outside of their jurisdiction or legal authority, the resolution authority should cooperate and coordinate with relevant supervisors and resolution authorities in the relevant jurisdictions, to the extent necessary and appropriate.

Unless otherwise specified by the resolution authority, resolution powers exercised on a TU (e.g. to cease writing business) should also apply to the legal entity’s branches. However, the resolution authority responsible for a branch can also exercise powers toward the branch. In either case, the
resolution authorities responsible for the branch and the TU should consult and cooperate with one another.

12.8.16 The resolution authority may choose which power, or which combination of powers, is applied to which entity within the group. Different types of powers may be applied to different parts of the entity's business.

12.9 Legislation provides that the supervisor is involved in the initiation of the liquidation of a TU (or a branch of a foreign TU in its jurisdiction).

12.9.1 Legislation should define the involvement of the supervisor in a liquidation which promotes the protection of takāful participants. The supervisor should be authorised to initiate, or should be involved in the liquidation of a TU, or a branch of a foreign TU in its jurisdiction.

12.9.2 In many jurisdictions, all resolution actions, including liquidation, may only be initiated by the supervisor and/or resolution authority. However, in some jurisdictions, the liquidation process can be initiated by another person (such as a creditor of the TU, the TU entity itself, or the court). If legislation permits another person to initiate liquidation, it should: (i) require prior approval of the supervisor; or (ii) at a minimum, require prior coordination with the supervisor. If legislation permits another person to initiate liquidation without such prior approval or coordination, it should provide that the supervisor may challenge the person’s action.

12.10 Legislation provides a high legal priority to takāful participants’ claims within the liquidation claims hierarchy.

12.10.1 Takāful participants should receive high legal priority in the liquidation of a TU (or of a branch) so that takāful participants rank above ordinary unsecured creditors. However, it is common in many jurisdictions that a higher priority is given to a limited number of other categories of claims. These may include claims:

- by liquidators, such as claims corresponding to expenses arising from the liquidation procedure;
- by employees;
- by tax or fiscal authorities;
- by social security systems; and
- claims on assets subject to rights in rem (e.g. through collateral, lien, mortgage).

12.10.2 Where segregation of funds is practised, the legislation specifies the status of qard and qard facility in the liquidation claims hierarchy. Where qard and/or qard facility are assigned the status of capital resources for solvency purposes, takāful participants’ claims should rank above any outstanding qard or pledged qard facility in the event that a fund is wound up (whether or not as part of a winding-up of the entire TU). TCP 17: Capital Adequacy considers the status of qard that does not rank behind takāful participants’ claims in the event of insolvency.
12.10.3 In some jurisdictions, takāful participants receive higher priority but only on a determined part of the TU’s assets (e.g. the assets covering technical provisions). In such jurisdictions, with respect to this portion of the TU’s assets, takāful participants’ claims are generally subordinate only to liquidation expenses.

12.10.4 Mechanisms facilitating timely payment and, when needed, continuity of contracts should be in place. In some jurisdictions, a PPS or other protection mechanisms can contribute to a resolution and ensure timely payment of claims to takāful participants. Where a bridge institution is available, this can ensure continuity of takāful products in cases where no TU present in the market takes over the takāful portfolio of the TU that would otherwise be liquidated. A PPS or other protection mechanisms could also ensure compliance with the NCWOL principle by providing compensation to takāful participants so that none are worse off than in liquidation. In some jurisdictions, a PPS can only pay claims after liquidation has been initiated.

Safeguards

12.11 The resolution authority exercises resolution powers in a way that respects the liquidation claims hierarchy and adheres to the NCWOL principle. If the resolution authority departs from the general principle of equal treatment of creditors of the same class (pari passu), the resolution authority substantiates the reasons for such departure to all affected parties.

12.11.1 While respecting the liquidation claims hierarchy, the resolution authority could treat certain types of creditors differently from others in the same class of creditors’ hierarchy. In such cases, the reasons for such a treatment should be transparent and clearly explained. Concerned creditors should be protected by the NCWOL principle, and where they do not receive at a minimum what they would have received in a liquidation of the entity they should have a right to compensation.

12.11.2 For instance, different types of creditors could be:
   • two categories of takāful participants ranking pari passu where one is covered by a PPS while the other is not; or
   • two categories of creditors ranking pari passu but the creditors are different in nature (e.g. direct takāful participants versus cedants).

12.11.3 For instance, different treatment of a creditor could be:
   • settling contracts ranking pari passu at a different pace; or
   • reducing (writing down) contracts ranking pari passu at a different rate.

12.11.4 These options could be used provided this does not infringe the NCWOL principle. For instance, Figure 12.2 illustrates the takāful liabilities (TLs) of a TU (or fund of a TU) consisting of two portfolios (A and B), where the total assets amount to 120 but the TLs of each portfolio amount to 100.
Assuming that these two portfolios rank pari passu, each takāful participant would receive 60% of their credit in liquidation. The resolution authority could reduce the TLs of A to 80 and the TLs of B to 70 (e.g. in the event that a sound TU or sound TUs accepted to fund part of but not the whole shortfall). However, if the resolution authority reduces the TLs of B to 40, the resolution authority will need to provide compensation to takāful participants of portfolio B (in the amount of 20) in order to meet the NCWOL principle. This simplified example does not take account of potential PPSs which could pay some claims.

**Figure 12.2 Writing down contracts and NCWOL**

The resolution authority could take actions which could worsen the position of some creditors, provided that said creditors receive compensation sufficient to meet the NCWOL principle. Figure 12.3 illustrates this approach – it would be beneficial to takāful participant in portfolio B to have their takāful contracts transferred, but the portfolio transfer worsens the position of takāful participants in portfolio A. Takāful participants in portfolio A therefore should receive appropriate compensation to ensure that they are not worse off compared to a liquidation scenario prior to the portfolio transfer. This example does not take account of potential PPSs which could pay some claims.

**Figure 12.3 Partial transfer of portfolio and NCWOL**
12.12 Legislation provides whether takāful liabilities may be restructured and whether takāful participants may absorb losses.

12.12.1 In some jurisdictions, takāful liabilities may be restructured. Restructuring, limiting or writing down takāful liabilities may include:

- suspending or postponing payments to takāful participants;
- amending terms of takāful contracts;
- terminating or restructuring options provided to takāful participants;
- reducing the value of current and future benefits;
- early settling of contracts by payment of a proportion of the takāful liabilities to provide a more rapid and cost-effective resolution. This can apply to future-determined benefits but also, and in particular in the case of inward (accepted) retakāful/reinsurance, to future contingent claims; or
- restructuring retakāful/reinsurance contracts to allow losses to be imposed on cedants as appropriate.

12.12.2 In most cases, approval from the court is required for the restructuring, while in some jurisdictions the resolution authority is empowered to restructure all or part of takāful liabilities without court approval. Restructuring should only occur if it adheres to the NCWOL principle.

12.12.3 Where takāful liabilities may be subject to restructuring in resolution, the resolution authority should clearly communicate information (e.g. the processes through which such restructuring is undertaken and the extent to which takāful participants may be forced to absorb losses) to interested stakeholders.

Issues Specific to Groups and Branches

12.13 Where the TU belongs to a group and the head of the insurance group is located in the same jurisdiction as the legal entity, mechanisms are in place through which the head of the insurance group is able to be resolved.
12.13.1 When a TU is resolved, the resolution of, or the application of some resolution powers to, the head of the group may support or aid the orderly resolution of the TU and best ensure the protection of takāful participants.

12.14 The resolution authority has the authority to resolve a branch of a foreign TU located in its jurisdiction and, in such circumstance, coordinates and cooperates with the supervisor and/or resolution authority responsible for the TU.

12.14.1 The resolution authority responsible for a branch should have the ability to support a resolution carried out by the resolution authority of the TU which owns the branch or by the resolution authority responsible for the resolution of the insurance group to which the branch belongs.

12.14.2 The resolution process may differ in the jurisdiction of the branch and in that of the TU, due, among other things, to different insolvency laws and creditor hierarchies.

12.14.3 Where the resolution authority of the TU which owns the branch or the resolution authority responsible for the resolution of the insurance group to which the branch belongs are not taking action, or are acting in a manner that does not take sufficient account of the objectives of resolution in the branch jurisdiction, the resolution authority responsible for the branch may need to take actions of its own initiative.

12.14.4 Where the resolution authority for a branch takes resolution action of its own initiative, it should give prior notification and consult the supervisor or resolution authority of the TU which owns the branch and/or the supervisor or resolution authority of the takāful.

Issues Specific to Windows

12.15 Voluntary exit of takāful windows from the market, or resolution of such windows, is conducted in accordance with the provisions of this TCP mutatis mutandis.

12.15.1 The operators of takāful windows may wish to cease operation, transfer the funds managed by them as operators to a full-fledged TU, or convert the window into a full-fledged TU. In such cases, the provisions of this TCP for voluntary exit or transfer are applied to the extent relevant.

12.15.2 The supervisor assesses viability of a takāful window and applies criteria to determine when a window has become, or is likely to become, non-viable.

12.15.3 In the event that a takāful window becomes non-viable, or the host conventional insurer becomes non-viable, the supervisor and, where relevant, the resolution authority require the host conventional insurer to refrain from extraction of capital from the window until all entitlements of
takāful participants and beneficiaries under takāful contracts have been met.

12.15.4 The supervisor and, where relevant, the resolution authority coordinate with the supervisor and, where relevant, the resolution authority responsible for the host conventional insurer.

TCP 13: RETAKĀFUL AND OTHER FORMS OF RISK SHARING

The supervisor requires the TO to manage effectively its use of retakāful and other forms of risk sharing. The supervisor takes into account the nature of retakāful/reinsurance business when supervising retakāful based in its jurisdiction.

Introductory Guidance

13.0.1 “Retakāful" refers to a contractual arrangement for the pooling of risks managed by TOs (the cedants), whereby each TO cedes a portion of risks of takāful participants in contracts entered into, making a payment of contribution into a pool managed by a retakāful operator (RTO) under the principle of ta‘awun. If the event specified in the contract entered into by the cedant occurs, recoveries are paid from the pool to the extent provided for by the contract, for the indemnification of the cedant’s takāful participants collectively. Alternative retakāful arrangements may exist. For simplicity, this TCP uses “retakāful" to refer to both mainstream retakāful and other forms of risk sharing, to which the provisions of this TCP apply mutatis mutandis.

13.0.2 Retakāful activity may be compared to conventional reinsurance activity, which some TOs are known to make use of under certain circumstances (see Standard 13.1). Conventional reinsurance operates on a basis of risk transfer under a contract of conventional insurance between the cedant and the conventional reinsurer, in exchange for a premium. Other forms of risk transfer include alternative reinsurance arrangements, such as risk transfer to the capital markets. For simplicity, this TCP uses “conventional reinsurance” to refer to both mainstream conventional reinsurance and other forms of risk transfer that a TO might use.

13.0.3 Geographical diversification of risk, which typically involves risk sharing or risk transfer across jurisdictional borders, is a key element of a cedant’s and an RTO’s capital and risk management. Geographical diversification can also have an impact in the jurisdiction of the cedant – in particular, jurisdictions exposed to catastrophes. By ceding across borders the risk that covered events may occur, cedants in the jurisdiction, and the jurisdiction as a whole, can benefit from a reduced concentration of such risk exposures at the cedant and jurisdiction level, respectively. This may also contribute to the financial stability of the jurisdiction.
13.0.4 Cedants and retakāful undertakings (RTUs) may face external limitations to geographical diversification – for example, in the form of constraints to cross-border risk sharing or risk transfer. The supervisor should be aware of and take into account the potential impacts of such limitations on individual cedants and RTUs, as well as on the soundness and efficiency of the takāful sector.

13.0.5 Neither a retakāful contract nor a conventional reinsurance contract constitutes a legal transfer of the TO’s obligation to meet, from the funds of the TU, the underlying takāful participants’ entitlement to indemnification – unlike, for example, a novation. Nonetheless, retakāful and conventional reinsurance contracts have the effect of sharing or transferring part of the underlying risk in an economic sense. The supervisor should remain aware that while retakāful shares the risk covered by the cedant with the RTU and conventional reinsurance transfers it to the conventional reinsurer, it also creates other risks. In a standard transaction, the cedant mitigates the risk it has covered under takāful contracts it has entered into, and assumes other risks such as credit, operational and basis risk; the RTU assumes risks such as the covered risk itself, timing, operational and credit risk.

13.0.6 A retakāful contract is by nature a business-to-business transaction, made between professional counterparties as part of a wider risk and capital management approach. For this reason, the sort of asymmetry of expertise and knowledge associated with takāful contracts involving general consumers is usually not an issue in the retakāful sector, although some asymmetry of bargaining power can exist, depending on the precise dynamics of the market. Thus, typically, it is not necessary for the supervisor to seek the same level of protection for cedants as it does for general consumers (see TCP 19: Conduct of Business).

13.0.7 The supervisor should be able to assess whether cedants make effective use of retakāful and/or conventional reinsurance. This involves gaining an understanding of, and comfort with, at least:
- the cedant’s strategy and programme for the use of retakāful and, where permitted, conventional reinsurance;
- the systems of risk management and internal controls put in place in order to implement the strategy and execute the programme;
- the application of Sharī`ah governance in respect of the strategy and programme;
- the economic impact of the risk sharing and/or transfer originating from the cedant’s retakāful and/or conventional reinsurance programme; and
- the impact of retakāful and/or conventional reinsurance on the cedant’s liquidity management.

13.0.8 The standards and guidance under this TCP are applicable to TUs and RTUs. Thus, throughout this TCP:
- references to ceded conventional reinsurance should be taken to include ceded retrocession (i.e. conventional reinsurance ceded by RTUs);
• references to cedants should be taken to include ceding by RTUs (i.e. retrocedants); and
• references to RTUs and conventional reinsurers should be taken to include retrocessionaires (i.e. RTUs and conventional reinsurers that assume retakāful and conventional reinsurance, respectively, from ceding RTUs).

13.1 The supervisor requires a TO’s use of conventional reinsurance or alternative risk mitigation mechanisms to be subject to appropriate Sharī`ah governance.

13.1.1 The use of conventional reinsurance by a TO has implications for the TO’s ability to ensure that its operational activities are Sharī`ah-compliant. A perception of Sharī`ah non-compliance exposes a TO to reputational risk, potentially affecting the behaviour of takāful participants and potential takāful participants, as well as the possibility that income will require purification, so affecting the capital position of the TU.

13.1.2 The cession of risks to conventional reinsurers is often defended by reference to the precept of dharurah (necessity), the contention being that without such use of conventional reinsurance markets, TOs would be unable to maintain or to expand the level of their business. Reasons commonly advanced include a lack of capacity of appropriate quality in the retakāful sector. The desired qualities cited include financial strength, credit rating, expertise in handling the type of risk, ability to assist in managing claims, and diversification (i.e. the availability of a sufficient spread of capacity) of the desired quality such that a cedant does not assume an unacceptable concentration of exposure to a small number of RTUs.

13.1.3 The supervisor may not have authority or capability to form an opinion on whether the conditions for the application of dharurah, either generally or in any particular case, are met. Sharī`ah non-compliance risk, however, remains relevant to the supervisory objectives of takāful supervisors, whether or not those supervisors are themselves responsible for the enforcement of Sharī`ah in firms that they supervise. Supervisors therefore require appropriate Sharī`ah governance of decisions to make use of conventional reinsurance (see TCP 8: Sharī`ah Governance).

13.1.4 The conditions considered by a TO’s Sharī`ah board to justify a finding of dharurah may change over time, creating a need for periodic review of decisions in this area. Therefore, decisions that the use of conventional reinsurance is justified should clearly specify a term within which review is required, or conditions that would trigger a review. Review should take place at least annually.

13.1.5 Similar considerations apply to the use of alternative methods of risk transfer or sharing, which should also undergo appropriate Sharī`ah scrutiny before implementation.
In the event that a TO makes use of conventional reinsurance arrangements or alternative methods of risk transfer, the supervisor applies the standards and guidance text of this TCP as if “retakāful” included retakāful and/or conventional insurance, and “risk sharing” included risk sharing and/or risk transfer, having reference also, where necessary, to ICP 13 for the purposes of supervising conventional reinsurance arrangements of a TO (reading “reinsurance” as conventional reinsurance and/or retakāful, and “risk transfer” as risk transfer and/or risk sharing). The purpose of this approach is to ensure that the supervisor considers the interplay of risks in a TO where both retakāful and conventional reinsurance are used.

13.2 The supervisor requires ceding TUs to have a retakāful programme that is appropriate to their business and part of their overall risk and capital management strategies.

13.2.1 A ceding TU’s risk and capital management strategies should clearly articulate the part played by retakāful – in particular:
• the objectives that are pursued by using retakāful;
• the risk concentration levels and ceding limits as defined by the ceding TU’s risk appetite; and
• the mechanisms for managing and controlling retakāful risks.

13.2.2 When articulating the part played by retakāful in the overall risk and capital management strategies, the ceding TU should take into account its business objectives, levels of capital and business mix, with particular reference to:
• risk appetite (both gross limit and net retention);
• peak exposures and seasonality in the takāful book;
• levels of diversification in the takāful book; and
• appetite for credit risk posed by retakāful.

13.2.3 The retakāful programme comprises the detailed implementation of the retakāful-related elements of the risk and capital management strategies in terms of coverage, limits, deductibles, layers, signed lines and markets used. It should reflect the ceding TU’s overall risk appetite, comparative costs of capital and liquidity positions determined in the retakāful strategy. Therefore, retakāful programmes can vary significantly in complexity, levels of exposure and number of takāful participants.

13.2.4 Where segregation of funds is practised, the retakāful programme should reflect the TO’s risk appetite, comparative costs of capital and liquidity positions determined in the retakāful strategy assessed at the level of the segregated fund. The retakāful programme of a TU may therefore involve particular complexity.

13.2.5 In some instances, a TU may have a business strategy and risk appetite to retain all risk, and therefore a retakāful programme would not be necessary.
13.2.6 Senior management develops the retakāful-related elements of the risk management strategy as well as the retakāful programme. Senior management is also responsible for establishing appropriate systems and controls to ensure that these are complied with. The board is responsible for approving the strategy and ensuring an appropriate oversight and consistent implementation of the retakāful programme.

13.2.7 Senior management of the TO should regularly review the performance of its retakāful programme to ensure that it functions as intended and continues to meet its strategic objectives (where segregation of funds is practised, for each fund that it manages). It is likely that such a review would take place as part of the feedback loop that is part of the risk management framework.

13.2.8 The supervisor should understand the ceding TU’s business objectives and strategies, and how retakāful fits into these, and should assess the extent to which objectives and strategies are adequately reflected in the retakāful programme. The supervisor should challenge the ceding TU where it identifies inconsistencies between the objectives and strategies and the retakāful programme.

13.2.9 The supervisor’s assessment of a ceding TO’s retakāful programme should be based on a number of factors, such as the:

- structure of the programme, including any alternative risk mitigation mechanisms;
- proportion of business ceded so that the net risks retained are commensurate with the cedant’s financial resources and risk appetite (where segregation of funds is practised, at the level of each fund);
- financial condition and claims payment record of the RTOs in question (both in normal and stressed conditions, and where relevant, at the level of the retakāful fund into which business is ceded);
- levels of exposure to a single RTO or different RTOs being part of the same group;
- extent of any credit risk mitigation in place;
- expected resilience of the retakāful and/or conventional reinsurance programme in stressed claims situations, including stress related to the occurrence of multiple and/or catastrophic events;
- cession limits, if any, applicable in the jurisdiction;
- the supervisory regime in place in the jurisdiction of the RTO or conventional reinsurer;
- level of effective risk mitigation; and
- extent to which relevant functions are outsourced by the ceding TO, including the criteria for the selection of retakāful brokers.

Group Perspectives

13.2.10 The group-wide supervisor should require a retakāful strategy for the insurance group that includes the following issues:

- its interaction with the group-wide risk and capital management strategies;
• how the risk appetite is achieved, on both a gross limit and net retention basis;
• the appetite for retakāful credit risk, including approved security criteria for retakāful transactions and aggregate exposure criteria to individual or related retakāful;
• the autonomy afforded to individual TUs to enter into “entity-specific” retakāful arrangements, and the management and the aggregation of these exposures in the group-wide context;
• procedures for managing retakāful recoverables, including required reporting from TOs;
• intra-group retakāful strategy and practice; and
• use of alternative risk mitigation mechanisms, including capital markets’ risk-sharing products.

13.3 The supervisor requires TOs of ceding TUs to establish effective internal controls over the implementation of their programme.

13.3.1 Control of the retakāful programme should be part of the ceding TU’s overall system of risk management and internal controls (see TCP 9: Risk Management and Internal Controls). The supervisor should require that the controls and oversight in place are suitable in the context of the ceding TU’s business.

13.3.2 Where segregation of funds is practised, the controls and oversight in place must pay due regard to that segregation. This also applies where segregation of funds is practised in an RTU to which risk is ceded.

13.3.3 The TO of the ceding TU should ensure that the characteristics of its retakāful programme, including the credit risk posed by the RTU, are reflected in its capital adequacy assessment as well as its ORSA (see TCP 16: Enterprise Risk Management for Solvency Purposes).

Credit Risk Posed by the RTU

13.3.4 When developing the retakāful programme, the TO of the ceding TU should consider its appetite for retakāful credit risk. RTUs may face solvency issues, leading to delayed payment or default, and this can have significant consequences for the solvency and liquidity of the ceding TU.

13.3.5 In practice, TOs of ceding TUs have various options for mitigating retakāful credit risk – for example:
• establishing criteria on the financial condition;
• setting limits on risks ceded to a single RTU;
• ensuring a spread of risk among a number of RTUs;
• incorporating rating downgrade or other special termination clauses into the retakāful contract;
• requiring the RTU to post collateral (the ability to require this may depend upon the relative commercial strengths of the ceding TU and RTU);
• proactively monitoring takāful claims recoveries; and
• withholding the RTU’s funds.

13.3.6 However, in considering options for mitigating credit risk, TOs of ceding TUs should consider whether the RTU operates on a basis of segregation of funds, such that entitlements under retakāful contracts may be valid only against one takāful fund of the RTU. In such cases, credit risk must be assessed having regard to the fund.

13.3.7 The availability of some means of credit mitigation may be limited so far as a TO is concerned, due to its need to maintain Shari`ah compliance in its operations (and the need of an RTO to do so also). Even where this is not the case, TOs should ensure that arrangements for collateral are subject to appropriate Shari`ah governance, and may seek confirmation from the RTO that the arrangement has been approved by its own Shari`ah governance function.

Approved Security Criteria

13.3.8 The TO of the ceding TU should have in place procedures for identifying retakāful that meet its security requirements. If the TO of a ceding TU develops a pre-approved list of RTUs, there should also be processes for dealing with situations where there is a need to assess RTUs outside any pre-approved list. TOs of ceding TUs may have their own credit committees to make their own assessment of the risk.

13.3.9 The TO of the ceding TU should take into consideration any segregation of funds in an RTU to which it cedes risk, to ensure that security risk is not assessed by reference to capital resources of the RTU to which the TU as cedant to a particular fund would not have access.

13.3.10 In line with other approaches to identifying appropriate RTUs, any approved security criteria should be derived from a high-level statement of what retakāful security will be acceptable to the ceding TU, which may be based on:
• external opinions;
• the TO of the ceding TU’s own view of the RTU;
• minimum levels of capital;
• duration and quality of relationship;
• expertise of the RTU;
• levels of retrocession;
• retakāful brokers’ security criteria; or
• a mixture of these and other factors.

Aggregate Exposure Limits or Guidelines

13.3.11 A TO of a ceding TU should set prudent limits or guidelines reflecting the security and size of the RTU, in relation to its maximum aggregate exposure to any one RTU or to a group of related RTUs, which would be complementary to any supervisory limits or guidelines.
13.3.12 The TO of a ceding TU should have in place procedures for monitoring this aggregate exposure to ensure that these limits or guidelines are not breached. The TO of the ceding TU should also have procedures to manage excess concentrations going forward, such as bringing them back within limits or guidelines.

13.3.13 In setting and monitoring aggregate exposure limits or guidelines, the TO of the ceding TO takes into consideration that it may have exposures to different funds managed by an RTO, whose capital resources are not fungible. It may be appropriate to set exposure limits or guidelines for individual funds.

Matching of Underlying Underwriting Criteria

13.3.14 The TO of the ceding TU should give due consideration to the risk posed by a mismatch in terms and conditions between retakāful contracts and the underlying policies. The ceding TU may bear a greater net exposure than it initially intended because of this gap.

Criteria and Procedures for Purchasing Facultative Cover

13.3.15 The TO of the ceding TU should have appropriate criteria in place for the purchase of facultative coverage. Any facultative retakāful coverage bought should be linked to the procedures for aggregations and recovery management.

13.3.16 The TO of the ceding TU should have a specific process in place to approve, monitor and confirm the placement of each facultative risk. If facultative retakāful is necessary to ensure that acceptance of a risk would not exceed maximum net capacity and/or risk limits, such retakāful should be secured before the ceding TU accepts the risk.

Operational Risk Related to Contract Documentation

13.3.17 In order to reduce the risk and scope of future disputes, the TOs of the ceding TU and the RTU should have in place processes and adequate controls to document, clearly and promptly, the principal economic and coverage terms and conditions of retakāful contracts.

13.3.18 The TOs of ceding TUs and RTUs should finalise the formal retakāful contract without undue delay, ideally prior to the inception date of the retakāful contract.

13.3.19 All material reporting due to and from RTUs should be timely and complete, and settlements should be made as required by the retakāful contract.

13.3.20 The TO of the ceding TU should consider how its retakāful or conventional reinsurance contracts will operate in the event of an insolvency of itself or the RTU concerned, including in the event that a segregated fund is
required to be wound up, if that may occur without the TU (or RTU) being itself placed into insolvency.

13.3.21 The supervisor should have access, on request, to material retakāful documentation. In case of indications of significant uncertainties in terms of retakāful documentation, the supervisor should take into account the resulting underwriting, operational and legal risks when considering the effects of retakāful on the ceding TU’s solvency.

13.4 The supervisor requires a TO to attribute cash flows relating to retakāful arrangements in a manner that pays due regard to the interests of its takāful participants.

13.4.1 Where segregation of funds is practised, the attribution of retakāful cash flows to one fund or another is of importance to the fair treatment of takāful participants, particularly where takāful participants in a fund are entitled to distribution of underwriting surplus in that fund. In any case, however, even if surpluses are directed to charitable activities or retained as capital, the correct attribution of retakāful cash flows has an ethical dimension and is of relevance to the supervisory objectives of takāful supervisors.

13.4.2 Ethical considerations also arise in the event that a TO enters into a contract of retakāful that provides protection to more than one fund – or, if more than one TO enters into a contract of retakāful, that provides protection to both. Particularly in the case of non-proportional covers with event or aggregate deductibles, there is a risk that the deductible or the indemnity is not apportioned fairly between the two funds (in the first case) or the two TUs (in the second case).

13.4.3 Supervisors should require TOs to document their policy regarding the attribution of cash flows under retakāful contracts entered into by them as cedant, including justification of that policy by reference to fairness as between takāful participants and shareholders, fairness between different groups of takāful participants (if that is relevant to the case), and Sharī`ah compliance (following exercise of appropriate Sharī`ah governance).

13.4.4 At a minimum, the policy should cover the attribution of outflows in the form of retakāful contributions and wakālah fees or other remuneration to the RTO, and inflows in the form of ceding commissions, profit commissions, brokerage, recoveries and distributions of surplus.

13.4.5 Supervisors should require TOs and RTOs to have in place systems and controls to ensure implementation of the documented policy.

13.4.6 Supervisors should consider specifying default actions in respect of attribution of cash flows, based on the principle that takāful participants (in the form of the cedant’s PRF) should receive the benefit (in the sense of indemnities or reductions/refunds of expenses from RTOs) associated with costs charged to the PRF, requiring cedants to justify any departure from the default.
Supervisors should require TOs proposing to engage as cedants in *retakāful* agreements involving profit commission arrangements to have in place a process for subjecting the proposed transaction to appropriate Shari`ah governance. The payment of a profit commission based upon the result of a single cedant’s risks is considered by some to conflict with the principle of risk sharing. As part of its supervisory activity, the authority should consider whether the process has been followed (and the advice received followed) and, if necessary, assess the effectiveness of the process with regard to the information provided to the Shari`ah governance function, the resources available to them to carry out their duties and the nature of the advice given.

The Shari`ah governance process should include provision for consideration of all factors relevant to the decision, and for periodic review of decisions to allow for arrangements of the types described, in case conditions have changed such that the decision requires modification.

The supervisor requires ceding TUs to demonstrate the economic impact of the risk sharing originating from their *retakāful* contracts.

- **13.5.1** The supervisor should regard as a *retakāful* contract an agreement that shares sufficient *takāful* risk to be considered as *takāful* under jurisdictional rules.

- **13.5.2** In general, a contract should be considered as a loan or deposit if, during its development, the ceding TU has the unconditional obligation to indemnify the RTU for any negative balances that may arise out of the contractual relationship. This characteristic does not result in risk sharing. All liabilities of the ceding TU should be contingent on the proceeds of the underlying *takāful* business.

- **13.5.3** Upon request from the supervisor, the TO of the ceding TU should provide sufficient information about its *retakāful* contracts to allow the supervisor to make informed judgments about the substance of the risk sharing (i.e. the degree of risk sharing in an economic sense).

- **13.5.4** Where there are concerns of inappropriate reporting with respect to the degree of risk sharing, the supervisor should assess the substance of the *retakāful* contract entered into by the ceding TU and how it has been reported by the ceding TU. Further, the supervisor should be able to assess the impact that the ceding TU’s *retakāful* contracts have on the ceding TU’s capital requirements. The supervisor should challenge senior management of the TO of the ceding TU on the purpose of individual contracts, where appropriate.

*Finite Retakāful*
13.5.5 “Finite *retakāful*” is a generic term that, for the purposes of this TCP, is used to describe a spectrum of *retakāful* arrangements that share or transfer limited risk relative to aggregate premiums that could be charged under the contract.

13.5.6 The supervisor should pay particular attention to *retakāful* contracts that have, or appear to have, limited levels of risk sharing or transfer which may change over the duration of the contract. Only the amount of risk shared/transfered under finite *retakāful* contracts should be included in the regulatory capital calculations of the ceding TU.

### 13.6 When supervising ceding TUs purchasing *retakāful* across borders, the supervisor takes into account the supervision performed in the jurisdiction of the RTU.

13.6.1 The cross-border nature of *retakāful* transactions, together with the relative sophistication of the market participants involved in *retakāful*, are key elements that the supervisor should consider when supervising ceding TUs.

13.6.2 Taking into account the supervision performed in the jurisdiction of the RTU may help the supervisor to assess the overall risk profile of the ceding TU. This can be done, for example, by reviewing the supervisory framework and practices in the jurisdiction of the RTU, or by engaging in supervisor-to-supervisor dialogue.

*Supervisory Recognition*

13.6.3 The supervisor can benefit from relying on supervision performed in the jurisdiction of the RTU. Benefits may include, for example, strengthened supervision as well as a more efficient use of resources by the supervisor of the ceding TU.

13.6.4 Where supervisors choose to recognise aspects of the work of other supervisory authorities, they should consider putting a formal supervisory recognition arrangement in place (see TCP 3: *Information Sharing and Confidentiality Requirements*).

13.6.5 Supervisory recognition can be conducted through unilateral, bilateral and multilateral approaches to recognition. All three approaches recognise the extent of equivalence, compatibility or, at least, acceptability of a counterparty’s supervisory system. Bilateral and multilateral approaches typically incorporate a mutuality component to the recognition element, indicating that this is reciprocal.

### 13.7 The supervisor requires the TO of the ceding TU to consider the impact of its *retakāful* programme in its liquidity management.

13.7.1 Given the nature and direction of cash flows within a ceding TU, liquidity risk historically has not been considered to be a major issue in the *takāful*
sector. However, there can be liquidity issues within an individual ceding TU which could arise specifically from the ceding TU's *retakāful* programme.

13.7.2 *Retakāful* contracts do not remove the TU’s underlying legal liability to its *takāful* participants. The TU remains liable to fund (from the relevant segregated fund, where segregation of funds is practised), all valid claims under *takāful* contracts it has entered into, regardless of whether or not they are ceded under *retakāful* arrangements. For this reason, a large claim or series of claims could give rise to cash-flow difficulties if there are delays in collecting from RTOs or in the TO of the ceding TU providing proof of loss to RTOs. Where segregation of funds is practised, liquidity strain could emerge in a particular fund. It is possible that liquidity in the SHF could be made available to the fund in question by way of *qard*. This may not, however, be practicable if the liquidity strain arises from a large claim in a fund that relies heavily on *retakāful*.

13.7.3 The supervisor should require the TOs of ceding TUs to take appropriate measures to manage their liquidity risk, including funding requirements in adverse circumstances. As with all risks, the TU should develop its own response to the level of risk it faces and the supervisor should assess these responses. There are a number of ways in which liquidity risk may be mitigated. For example, some TUs choose to arrange a line of credit from a bank in order to deal with short-term liquidity issues.

13.7.4 Ceding TUs may make arrangements with their RTUs in order to mitigate their liquidity risk. These arrangements, if used, may include clauses that trigger accelerated payment of amounts due from RTUs in the event of a large claim and/or the use of collateral or deposit accounts, giving ceding RTUs access to funds as needed. Use of such arrangements is a commercial matter between the ceding TU and RTU.

13.7.5 External triggers can give rise to liquidity issues, especially where RTUs have retroceded significant amounts of business. If a *retakāful* contract contains a downgrade clause that gives the ceding TU the right to alter the contract provisions, or obliges the RTU to post collateral with a ceding TU to cover some or all of its obligations to that ceding TU, such action may cause liquidity issues among RTUs and may be procyclical. Therefore, the supervisor should be aware of the potential consequences of such triggers for the overall efficiency and stability of the market.

13.8 Where a TO makes use of arrangements other than *retakāful* to share risk, the supervisor understands and assesses the structure and operation of such arrangements and addresses any issues that may arise.

13.8.1 A wide range of complex techniques has been developed in the conventional insurance sector to enable the transfer of insurance risk to the capital markets.
13.8.2 In general, arrangements used to enable risk transfer to the capital markets operate like mainstream conventional reinsurance. For example, risk is transferred via a conventional reinsurance contract, with terms and conditions similar to any other conventional reinsurance contract. Further, the risk-assuming entity is a conventional reinsurer subjected to licensing conditions like any other conventional reinsurer. The defining feature of these risk transfer arrangements is the direct funding of the conventional reinsurance risk exposure with funds raised, often exclusively, in the capital markets.

13.8.3 The ability of TOs to make use of such arrangements is likely to be limited to circumstances where, with approval from its Shari`ah board, a TO cedes risk on a conventional reinsurance basis. As with any instance of cession on a conventional reinsurance basis, the supervisor requires the TO to ensure appropriate Shari`ah governance of the arrangement and considers the requirements of ICP 13: *Reinsurance and Other Forms of Risk Transfer* in relation to the arrangement.

13.8.4 If a TO enters into arrangements that share risks in a different manner from a typical retakāful contract, the supervisor understands the structure of the arrangement and considers the implications for risk profile, fairness to takāful participants and capital adequacy of the TU. For example, a TO may seek to enter into a swap arrangement with another TO, whereby in place of retakāful contribution the two TUs exchange cession of risk exposures on a risk-sharing basis. Such an arrangement may be attractive in terms of diversification for both TUs; however, it potentially exposes takāful participants to unexpected risks. The supervisor also requires the TO to ensure appropriate Shari`ah governance of the arrangement.

13.8.5 The supervisor should also be alert to the possibility that a TU for which the supervisor has supervisory responsibility enters into an arrangement that would not be permitted for a counterparty in the jurisdiction, but where the counterparty is located in a different jurisdiction that does permit such an arrangement. In such a case, the supervisor of the TU considers, among other things: whether the counterparty is licensed in the jurisdiction where the arrangement is being entered into; the supervisory regime to which the counterparty is subject in its jurisdiction; the extent to which the TO has adequately provided for the identification, assessment and management of the risks associated with sharing insurance risk with the counterparty (e.g. credit risk, basis risk); and whether the TO has applied appropriate Shari`ah governance in respect of the arrangement.

TCP 14: VALUATION
The supervisor establishes requirements for the valuation of assets and liabilities for solvency purposes.

*Introductory Guidance*
14.0.1 Although methodologies for calculating items in general purpose financial reports may be substantially consistent with the objectives of valuation for solvency purposes, this may not always be the case, considering the differing purposes of general purpose financial reporting and solvency determination. The IFSB believes it is essential that differences between general purpose financial reports and published regulatory reports are publicly explained and reconciled.

14.0.2 The IFSB considers that differences between technical provisions for general purpose financial reports and published regulatory reports should be publicly explained and reconciled in terms of differences in data, discount rate, methodology and assumptions used together with the rationale for why any different approach is appropriate for solvency purposes.

14.0.3 To the extent that measurement methods of financial reporting standards, including international financial reporting standards (IFRS), are consistent with this TCP, supervisors may regard valuations that are in accordance with those financial reporting standards as being compliant with this TCP.

14.0.4 The context and purpose of the valuation of assets or liabilities of a TU are key factors in determining the values that should be placed on them. This TCP considers the valuation requirements that should be met for the purpose of the solvency assessment of TUs within the context of risk-based solvency requirements that reflect a total balance sheet approach on an economic basis\(^\text{14}\) and address all reasonably foreseeable and relevant risks.

14.0.5 Standard 17.1 states that the supervisor requires a total balance sheet approach\(^\text{15}\) to be used in the assessment of solvency to recognise the interdependence between assets, liabilities, regulatory capital requirements and capital resources, and requires that risks are appropriately recognised. Such an approach ensures that the determination of available and required capital, including at the level of each segregated fund, is based on consistent assumptions for the recognition and valuation of assets and liabilities for solvency purposes.

14.0.6 To achieve consistency with this approach to setting capital requirements in the context of a total balance sheet approach, capital resources should broadly be regarded as the difference between assets and liabilities, but on the basis of their recognition and valuation for solvency purposes. This description applies also at the level of each fund (including, where relevant,

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\(^{14}\) An economic basis may include amortised cost valuations and market-consistent valuations that comply with this TCP.

\(^{15}\) The total balance sheet approach is an overall concept rather than one which implies the use of a particular methodology such as a cost of capital method or a percentile method.
the shareholders’ fund) where segregation of funds is practised and capital adequacy is assessed at the fund level.

Solvency Purposes

14.0.7 The valuation "for solvency purposes" referred to in this TCP is the valuation of the assets and liabilities used within the broad concept of a risk-based solvency assessment of TUs.

14.0.8 Solvency assessment results from the application of supervisory judgment to various measures and estimates of a TU’s current financial position and future financial condition which serve to demonstrate the TU’s ability to meet its obligations to takāful participants or others with entitlements under takāful contracts when they fall due. A set of financial statements, which may differ from those used for general purpose financial reporting, is useful in this regard. To distinguish them, this TCP refers to the financial statements used for solvency assessment as “regulatory financial statements”. Such statements include a regulatory balance sheet and regulatory capital requirements. For the purposes of this TCP, “valuation for solvency purposes” refers to valuation of assets and liabilities in the regulatory financial statements. The overall solvency assessment may use information additional to the regulatory financial statements, such as:

• stress and scenario testing;
• the TO’s ORSA for the TU; and
• relevant disclosure.

14.0.9 Technical provisions are a significant component of valuation for solvency purposes. They include a margin for risk appropriate for solvency purposes. Regulatory capital requirements are another component of the solvency assessment, and they include further allowance for risk so that when taken together, they are sufficient to ensure that policy obligations are satisfied with the probability of sufficiency required by the supervisor.

14.0.10 In adverse circumstances, certain assets may be considered to have reduced or nil value. Consequently, in the capital adequacy assessment such assets may be excluded from or have reduced value in capital resources. Alternatively, a capital requirement may be set to cover the potential shortfall in value. Such adjustments are part of the process of determining capital requirements and/or capital resources and are covered by TCP 17: Capital Adequacy. These adjustments are shown separately from asset values in the regulatory financial statements. This enables improved transparency, consistency and comparability.

14.1 The valuation addresses recognition, derecognition and measurement of assets and liabilities.

14.1.1 Assets and liabilities should be recognised and derecognised to the extent necessary for risks to be appropriately recognised. Such recognition/derecognition principles may differ from those used for general purpose financial reporting in a jurisdiction.
14.1.2 Recognition of takāful contracts as part of the valuation of technical provisions is a significant issue for TUs and supervisors. There are two key possible points of recognition – on entering into a binding contract (the bound date) and the inception date of the contract. In principle, the bound date is the date at which an economic obligation arises. However, in practice, these dates are only likely to be significantly different for certain classes of general takāful.

14.1.3 Contracts for ceded retakāful should be recognised and valued so as to correspond to the recognition of the risks which they are mitigating. Where a current retakāful contract is contracted to cover future direct policies, the value of the retakāful policy should not include any amount in respect of future direct policies that have not been recognised.

14.1.4 A takāful contract liability (or a part of a takāful contract liability) within technical provisions should be derecognised when, and only when, it is extinguished – that is, when the obligation specified in the takāful contract is discharged or cancelled or expires.

14.1.5 The cedant’s entering into a retakāful arrangement should not result in the derecognition of technical provisions unless the entry into that arrangement results effectively in the extinguishment or novation of the takāful contracts. In the event that, in exceptional circumstances and with the approval of its Shari’ah board, a cedant enters into a conventional reinsurance arrangement, that arrangement similarly does not result in derecognition of technical provisions unless the test of extinguishment or novation of the primary contracts is met.

14.2 The valuation of assets and liabilities is undertaken on consistent bases.

14.2.1 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 the financial position of a TU relative to other TUs. It provides reliable information on which to base the actions that are taken by TOs and their supervisors in respect of those positions.

14.2.2 The overall financial position of a TU should be based on the consistent measurement of assets and liabilities, the explicit identification and consistent measurement of risks and their potential impact on all components of the balance sheet. This consistency should apply to all assets and liabilities, including assets in excess of the liabilities, and extend across TUs and time periods so as to achieve comparability.

14.2.3 Undertaking valuation on consistent bases means that differences in 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 differences in methodology or
assumptions. Such consistency may be applied at different levels, such as segments within a company or a group.

14.2.4 Where segregation of funds is practised, each fund forms a segment within the TU. In addition, where capital resources within the SHF are earmarked for potential provision as qard to another fund, the assets earmarked also form a segment in this context.

14.2.5 Observed market valuations or amortised cost valuations may be used for some assets and liabilities, while valuation models, such as discounted cash flow models, may be used for other assets and liabilities. Calibration of such discounted cash flow models to market valuations or amortised cost of other assets and liabilities can be of assistance in achieving consistency.

14.2.6 The specific characteristics of takāful contracts, financial instruments and data available may vary within and across jurisdictions. Consistency in the valuation of assets and liabilities means that such variations can be explained in terms of the differences in the nature of the cash flows valued in each jurisdiction.

14.2.7 Regulatory capital requirements are determined using a consistent treatment of the valuation of assets and liabilities. Consistency in the valuation of assets and liabilities for solvency purposes does not necessarily mean that a single valuation basis is used for all assets and liabilities. The balance sheet, when taken together with capital requirements, should result in an appropriate recognition of risks.

14.3 The valuation of assets and liabilities is undertaken in a reliable, decision-useful and transparent manner.

Reliability

14.3.1 The values placed on the assets and liabilities of a TU for solvency purposes should be a reliable measure of their value at the date of solvency assessment.

14.3.2 Objectivity is an important aspect of valuing assets and liabilities in a reliable manner, so that a valuation is not influenced inappropriately by a TO’s management. The valuation of assets and liabilities typically involves judgment – for example, expert judgment in assessing the relevance of data and deriving assumptions. Consistent with reliability of outcome, subjectivity in valuation should be reduced as far as practicable. This may be achieved by using information available from effective internal control processes, market valuations, and other relevant current or factual information, by applying professional standards and subjecting valuations to independent review. The supervisor should require a valuation methodology which uses information provided by the financial markets and generally available data on takāful technical risks. Company-specific information may be appropriate – for example, where the TU’s business
model and practices are sufficiently substantiated as representative of the portfolio and similar information is used in market valuations.

**Decision Usefulness**

14.3.3 In the context of this standard, "decision useful" means useful in making judgments for solvency purposes. It should be recognised that, in valuing assets and liabilities in a reliable manner, and in reducing the subjectivity in the valuation, it may not be appropriate to eliminate subjectivity completely. A method that provides a single value without the need for judgment may be less decision useful than one that produces a range of reasonable values from which a value is selected by applying judgment. A method that produces a decision-useful outcome should take precedence over one that does not.

14.3.4 In some jurisdictions, enforcement actions can only be based on objective calculations. In those jurisdictions, an objective calculation should take precedence over one based on subjective assumptions and methods. Supervisors may need to provide greater specificity on assumptions (e.g. mortality and discount rates) and methods for regulatory purposes. Specified methodology should include a margin for risk that is appropriate for a valuation done for solvency purposes.

14.3.5 Decision-useful values may be derived from a range of sources, including market-consistent valuations, amortised cost valuations and other valuation models, such as discounted cash flow projection models.

14.3.6 Where there is a market for an asset or liability in which prices are quoted publicly and trades are readily available, the quoted prices could provide a decision-useful value of the asset or liability in the large majority of situations. Typically, there will be a range of market prices for the same item, and judgment will be needed in determining the final value.

14.3.7 In some circumstances, a market price may not necessarily provide a decision-useful basis for a valuation. If the reference market is dysfunctional or anomalous in its operation, a more reliable method of determining value based on more normal conditions may be appropriate. Such circumstances may occur, for example, if there is a high cost in making actual trades, trading is thin, independent pricing sources are not available or are limited, or the market is subject to distorting influences. The supervisor should evaluate such circumstances and, as a result, may conclude that the use of an alternative economic valuation is appropriate.

14.3.8 Amortised cost could be a decision-useful value for assets and liabilities where it is a reflection of the amount the TU will pay and receive over time, and fluctuations in market values are not indicative of the TU's ability to meet its obligations. Amortised cost may provide a pragmatic and decision-useful value when other valuation approaches are no more useful or reliable. It is useful to complement such valuations with sensitivity and adequacy testing.
A TO's modelling for the TU of its assets and liabilities may also provide a decision-useful value. The reliability of model results is enhanced through the use of TUs' and supervisors' best practices surrounding model governance, controls and independent review. Supervisory comparisons or benchmarking of modelling practices can further enhance the reliability of modelled results. Models can be used to apply common measurement criteria across all risks (e.g. same methodology, time horizon, risk measure, level of confidence, etc.).

The supervisor should evaluate the extent to which the time preference and risk adjustments add decision-useful information. Where this is not the case, the disclosure requirements may be relied upon. For liabilities subject to significant litigation uncertainty, it may not be appropriate to include estimates of time preference and risk in the reported liability, due to the unreliability of such adjustments.

Transparency

The solvency regime should be supported by appropriate public disclosure and additional confidential reporting to the supervisor. For example, explicit determination of the components of the technical provisions supports the objectives of transparency and comparability and facilitates convergence. Standards for public disclosure, including the valuation of assets and liabilities for solvency purposes, can be found in TCP 20: Public Disclosure and IFSB-25: Disclosures to Promote Transparency and Market Discipline for Takāful/Retakāful Undertakings.

TOs should provide sufficient information about the approaches they have taken to the valuation of assets and liabilities, describing how the principles of reliability, decision usefulness and consistency have been addressed. Transparency facilitates understanding and comparability within and across jurisdictions.

The valuation of assets and liabilities is an economic valuation.

An economic valuation is a valuation such that the resulting assessment of a TU’s financial position is not obscured by hidden or inherent conservatism or optimism in the valuation. Such an approach is appropriate in the context of risk-based solvency requirements which satisfy these TCPs and standards and shares their objectives of transparency and comparability.

Where segregation of funds is practised, the requirement to value assets and liabilities extends also to balances between funds (e.g. qardh).

An economic valuation of assets and liabilities reflects the risk-adjusted present values of their cash flows.
14.5.1 An economic value should reflect the prospective valuation of the future cash flows of the asset or liability, allowing for the riskiness of those cash flows and for time preference. An asset or a liability may have both cash inflows and cash outflows the net effect of which is a positive or negative value. Such a valuation is not necessarily determined directly using a discounted cash flow calculation. A current quoted market value or a current sale or purchase value may also reflect the prospective valuation of cash flows.

14.5.2 Supervisors should take into account all relevant information available about current market assessments of value and risk and the principles, methodologies and parameters used in the relevant markets for assessing the value of an asset or liability.

14.5.3 The historic cost of an asset or liability may not reflect a current prospective valuation of the future cash flows and may therefore not be consistent with the current economic valuation of other assets or liabilities. Historic cost generally does not reflect changes in value over time. However, amortised cost, which adjusts the historic cost of an asset or liability over time, may reliably reflect the value of future cash flows, when used in conjunction with an adequacy or impairment test.

14.5.4 Some jurisdictions utilise a subset of economic valuation known as market-consistent valuation, which is described further in Guidance paragraphs 14.5.5 to 14.5.11. Some jurisdictions use a subset of economic valuation known as amortised cost valuation, which is described further in Guidance paragraphs 14.5.12 to 14.5.18.

Market-Consistent Valuation

14.5.5 It may be appropriate to use market-consistent values for the economic valuation of assets and liabilities. A valuation that is based upon principles, methodologies and parameters that the financial markets would expect to be used is termed a market-consistent valuation. Where a range of assessments and approaches is evident from a market, a market-consistent valuation is one that falls within this range.

14.5.6 It may be well known to financial markets that the approach taken to market assessments for some assets and some insurance liabilities or their components uses modelling based on certain assumptions and techniques and portfolio-specific information as well as generally available data on takāful technical risks. A calculation consistent with this approach would be market consistent.

14.5.7 However, in exceptional circumstances there may be information additional to that on market assessments from the wider economy that should be taken into account – for example, where a market is anomalous, not operating effectively, or is subject to intervention from the relevant authorities (such as where a government/regulator intervenes in a major way by injecting money or taking control). Such action may be in response
to or the cause of distortions of supply and demand in relevant markets so that values determined in a market-consistent way may also be distorted temporarily.

14.5.8 A market-consistent value may not then be appropriate and a different value, which may, for example, be expected to be market consistent under more normal market conditions, may need to be determined to arrive at an economic valuation for solvency purposes. The extent to which this is appropriate is likely to vary according to market conditions in different jurisdictions. If such circumstances arise, supervisors should provide guidance as to the appropriate values or adjustments TOs should use for solvency purposes to reflect the risk-adjusted present value of their cash flows and maintain consistency, decision usefulness, relevance and transparency.

14.5.9 A sufficiently active market may exist for an asset or liability that in itself provides a measure of value that is market consistent. For other assets and liabilities, or when the market becomes illiquid, there may be no direct measure of value. However, relevant market information may be available regarding the assessment of components of the rights, obligations or risks of the asset or liability. If, for example, a component of the obligations of a takāful liability can be replicated using financial instruments for which there is a reliable market value, that value provides a reliable indication of the value for this component.

14.5.10 The market-consistent value of an asset or liability may be determined using different techniques, or a combination thereof. For example, in valuing technical provisions:
- if the takāful obligations are traded in a sufficiently deep and liquid market the observed prices may be used to arrive at a market-consistent value. The availability, decision usefulness and reliability of the prices should be taken into account when deriving the market-consistent value;
- if some or all of the cash flows associated with the takāful obligations can be replicated using financial instruments, the market value of the replicating financial instruments may be used as the value of those cash flows; and
- if the cash flows associated with the takāful obligations cannot be replicated perfectly, then the remaining cash flows may be valued using a discounted cash flow model. To be market consistent, the methodology used needs to deliver a proxy for market value based on market-consistent valuation principles and to reflect the uncertainty or unavailability of market information.

14.5.11 This approach to valuation is sometimes termed the “components approach”, under which risk components are valued at market value where such a value is ascertainable, decision useful and reliable; other components may need to be valued using marked-to-model methods. Separate components may, for example, be identifiable for takāful contracts which have an investment or deposit component and a takāful
risk component. The components approach helps to improve market consistency and reduce modelling error. It should be noted that where there is no sufficiently deep liquid market from which to determine a market-consistent value for a risk component, the additional liquidity risk needs to be considered.

**Amortised Cost Valuation**

14.5.12 It may be appropriate to use an amortised cost method for economic valuation of assets and liabilities. Amortised cost methods determine the value of an asset or liability at any point in time as the present value of future cash flows discounted at an appropriate discount rate, with an appropriate adjustment for risk.

14.5.13 Amortised cost may, however, be inappropriate as a method of valuation for some fixed-income assets that are invested in by TUs. The reliability of amortised cost as an economic valuation method is influenced by the degree of certainty of future cash flows. Because of the avoidance of *riba* in assets of TUs, future cash flows, particularly those on maturity, may not be certain. Similarly, avoidance of *riba* in contracts makes it less likely that TUs will have borrowings whose value should be determined on an amortised cost basis.

14.5.14 Where segregation of funds is practised, amortised cost may also be unsuitable as a method of valuation for balances between funds of a TU. For example, a *qarḍ* extended by the SHF to a *takāful* fund represents an asset of the SHF and a liability of the *takāful* fund. An amortised cost valuation of the asset that is based on cash flows arising from future surplus to be generated within the same TU would need to be based on realistic expectations of recovery rather than assuming that such surplus would arise. That valuation would reflect the perceived ability of the fund to repay the *qarḍ*. The valuation of the *qarḍ* liability in the fund, on the other hand, could not take into account that the fund’s ability to repay may have deteriorated since it assumed the liability (see Guidance paragraphs 14.6.3 and 14.6.4). \(^{16}\)

14.5.15 Supervisors may therefore decide to approach this method of valuation with caution, for solvency purposes in *takāful*.

14.5.16 The discount rate used in valuing assets under an amortised cost method equates the present value of expected contractual cash flows with the amount paid to acquire the asset. The price paid for an asset usually equals the market value at time of purchase. Since the price paid reflects the risk of the instrument at the time of purchase, an adjustment for the risk assessed at that time is automatically included in the discount rate.

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\(^{16}\) Valuation should be distinguished from write-off. A decision by the TO to write down the value of the asset in the SHF does not affect the existence of the asset in the SHF or the liability in the *takāful* fund. However, a decision to write it off irrevocably in the SHF extinguishes the asset and the liability, to the extent of the write-off.
14.5.17 When valuing both assets and liabilities under an amortised cost method, there is a close relationship between the discount rate and the provision for risk. The discount rate used may be based on the expected yield, after making allowance for default, of the supporting asset portfolio. Other combinations of discount rate and risk adjustment are possible.

14.5.18 When an amortised cost method is used, the values produced should be evaluated for adequacy at least annually. For assets, when the asset has been impaired to a significant degree, the carrying value of that asset should be adjusted to reflect that impairment. For liabilities, the value should be tested at least annually. When the liability value is found to be inadequate, it should be strengthened. Adjustments should also be made to reduce any significant, undue conservatism identified by the adequacy test.

14.6 The value of technical provisions and other liabilities does not reflect the TU's own credit standing.

14.6.1 To achieve consistent and reliable economic values of takāful portfolios for solvency purposes, the value of technical provisions should not reflect a TU's own credit standing. Takāful obligations are required to be met to the same level of confidence by all TUs in a jurisdiction and the value of an identical portfolio held by different TUs should not depend on the TU's credit standing. This also applies to the technical provisions of a retakāful provider.

14.6.2 However, the credit standing of a retakāful provider should be taken into account when considering the solvency of a cedant even if the contractual cash flows are the same. The risk of retakāful default could be covered either by the regulatory capital requirements or adjustments made to the value of assets in determining available capital. Alternatively, some allowance for the credit default risk could be made in valuing the retakāful asset directly.

14.6.3 The valuation of liabilities, other than technical provisions, should also not reflect the TU's own credit standing. This applies also to balances between funds; changes in the credit standing of a fund due, for example, to persistent deficits should not affect the valuation at which qard is held as a liability in the takāful fund, although they would be relevant to the valuation of the corresponding asset in the SHF.

14.6.4 Where the terms of the debt make it subordinate to theTU's obligations in respect of takāful contracts, the value of the debt may reflect the lower probability of repayment under subordinated debt and the lower capital needed to cover the risk of non-payment. Where segregation of funds is practised, this guidance applies where appropriate to qard balances between segregated funds.
14.7 The valuation of technical provisions exceeds the current estimate by a margin (margin over the current estimate).

14.7.1 Technical provisions are assets or liabilities that represent the economic value of the TU fulfilling its *takāful* obligations to *takāful* participants and other beneficiaries arising over the lifetime of the TU’s portfolio of *takāful* contracts. This includes a margin (margin over the current estimate, or MOCE) to cover the inherent uncertainty of those obligations.

14.7.2 The cash flows associated with fulfilling a TU’s *takāful* obligations include the premium/contributions receivable, the claims payable under the *takāful* contracts, any other contracts’ cash flows, and the future expenses of administering the contracts. They do not, however, include distributions of surplus from a segregated fund, unless such distributions are a contractual entitlement of the *takāful* participants and a present obligation of the TU, incapable of cancellation. Accumulations of such surplus in funds, notwithstanding that surplus is attributable to the *takāful* participants, represents capital of the fund rather than contractual cash flow under the *takāful* participants, until such time that its distribution (or application in some other way that would prevent it from absorbing losses) becomes foreseeable.

14.7.3 Where the SHF is entitled to receive surplus from a *takāful* fund (that is not in repayment of a *qard* liability), the supervisor should consider whether such payments from the fund are associated with fulfilling the TU’s *takāful* obligations. Payments that are obligatory and for which the necessary conditions have been met for them to be paid should be recognised as technical provisions or creditors of the *takāful* fund to the extent that those amounts are no longer able to absorb losses of the fund in question. However, amounts for which the necessary conditions have not been met for them to be paid to the SHF and which can absorb losses in the fund are, similarly to accumulated surplus attributable to *takāful* participants, capable of recognition as capital resources of the fund, until such time as the payment becomes foreseeable.

14.7.4 Where segregation of funds is practised, these future cash flows may emerge in different funds. In particular, expenses of administering the *takāful* contracts may arise in the SHF, for which the SHF has already been remunerated in the form of a *wakālah* fee. Technical provisions are valued separately for each fund, including the SHF, on a consistent basis. Cash flows between funds should also be taken into account in valuing technical provisions of a fund – for example, any *wakālah* fee to be paid by a *takāful* fund to the SHF, or any expenses recharged by the SHF to a *takāful* fund, so far as these future cash flows fall within the boundary of in-force *takāful* contracts. Such interdependent cash flows should be treated consistently, reflecting that they are internal to the legal entity. A cash flow between two segments of the same legal entity should not create a positive valuation difference in the entity as a whole. This means that, if one segment records an amount as due to another segment at a particular figure, the amount
due recorded in the other segment must not be higher (although it could be lower).

14.7.5 Acquisition costs are usually a significant component of a TU’s cash flows. After acquisition costs have been paid, future cash inflows may exceed future cash outflows.

14.7.6 Because a TU’s obligations under a takāful contract are inherently uncertain as to amount and/or timing, the present value of the cash flows associated with fulfilling them has a range of possible values with varying probabilities. The probability-weighted average of these present values is their expected present value (also called the “statistical mean”) and is termed the “current estimate of the cost of meeting the insurance obligations” (“current estimate”). Actuarial and statistical techniques may be used in determining the current estimate, including deterministic, analytical and simulation techniques.

14.7.7 In addition to covering the cash flows associated with fulfilling takāful obligations, a TU incurs the cost of covering the uncertainty inherent in those cash flows (e.g., through holding capital, or through hedging, retakāful or other forms of risk mitigation). TUs are required to maintain an amount such that the obligations under takāful contracts will be fulfilled with the claimant or beneficiary when they fall due. In principle, therefore, an economic value of the technical provisions exceeds the current estimate of the cost of meeting the takāful obligations by an amount covering this uncertainty. This excess is the MOCE. Where fund segregation is practised, the MOCE forms a part of the technical provisions in the fund responsible for fulfilling takāful obligations.

14.7.8 Where, for example, capital is required to give the level of confidence required by the solvency regime, the technical provisions should at least also cover the cost of holding that capital. In these circumstances, the MOCE might be seen as a provision for rewarding the capital committed to the business over the outstanding lifetime of the takāful contract. As the uncertainty reduces over time, so the MOCE will also reduce, gradually releasing it from the technical provisions. Equally, as uncertainty reduces, the required capital would also reduce in line with the revised risk profile.

14.7.9 Where the current estimate and MOCE are determined separately, determining these amounts at the level of each fund reflects the fact that capital is not fungible between the funds and must therefore be maintained at the necessary level in each fund. This may result in technical provisions that are higher than if the MOCE were determined for the TU as a whole.

14.7.10 It may not be necessary, in practice, to determine the current estimate and the MOCE separately. The solvency regime should require any method by which technical provisions are valued to be such that the value includes an explicit or implicit margin over the current estimate. For example, a reliable market valuation by reference to a sufficiently deep and liquid market may be expected automatically to include a MOCE.
A model which includes in its calculations an allowance for uncertainty up to the level of confidence required by the solvency regime is also capable of calculating the technical provisions directly. However, in this case, supervisors should consider whether the current estimate and MOCE should be separately reported to help ensure that technical provisions are consistent and reliable.

A change in underlying data or assumptions generating a change in current estimate and MOCE should be disclosed and justified so that consistency, reliability and relevance may be maintained and arbitrary changes over time are avoided.

The current estimate reflects the expected present value of all relevant future cash flows that arise in fulfilling takāful obligations, using unbiased, current assumptions.

The current estimate should reflect all future cash flows under an existing takāful contract to the extent that they are integral to the fulfilment of the obligations under that contract. This encompasses all cash flows, including non-guaranteed optional or discretionary cash flows (e.g. an ex gratia but customary payment on family takāful on the happening of certain events such as examination achievements), where they are established as stemming from the contractual relationship between the TU and the takāful participant. This reflects the commercial substance of the contract and, therefore, economic reality. However, distributions of surplus to takāful participants, where this is practised, are (where that surplus is capable of absorbing losses) considered to be capital outflows rather than being cash flows under a takāful contract and so are brought to account only when foreseeable. Calls for additional contributions (as opposed to contractual provisions allowing for retrospective adjustment of contributions on a contract to reflect experience on that contract) would similarly be capital inflows rather than contractual. This distinction is necessary in order to recognise the status of surplus as capital resources for solvency purposes, whereas indemnification of losses and future contractual contributions on an individual contract are properly reflected in technical provisions.

A takāful contract should, that apart, be considered as a whole. In particular, where the contract provides for the payment of future takāful contributions, such contributions are integral to the fulfilment of the obligations under that contract. Neither the TU nor the takāful participant is able to deal with one without simultaneously dealing with the other. To recognise one, the other must also be recognised. Valuation of the takāful liability requires consideration of all of the associated cash flows, including the contractual, contribution inflows. The uncertainty associated with those cash flows along with that of the other relevant cash flows are reflected in the probability weightings applied in calculating the current estimate.

Where segregation of funds is practised, it may be a permissible practice for takāful participants to make contributions to a savings account, from
which they are transferred systematically as *takāful* contributions into the fund in which *takāful* risk is borne. In such cases, it will be necessary to consider the boundary of both the contract for risk coverage and the contract obliging the *takāful* participant to make deposits and to ensure that the risk fund recognises only those cash flows within the contract boundary, whether or not the contract boundary for the savings account is identical.

14.8.4 To give clarity as to what constitutes a *takāful* contract for solvency purposes, the supervisory regime should specify the boundaries for *takāful* contracts which define the relevant cash flows to be included in determining the current estimate. The *takāful* contracts are subject to the following boundary constraints, if they exist:¹⁷

- contractual termination as extended by any unilateral option available to the *takāful* participant; or
- the TO having a unilateral right to cancel or freely re-underwrite the policy; or
- both the TO and *takāful* participants being jointly involved in making a bilateral decision regarding continuation of the policy.

14.8.5 The first boundary constraint excludes new business arising from the “rolling over” of the existing contract, except where such “rollover” is due to the exercising of an explicit option available to the *takāful* participant under the current contract. Contractual cash flows arising from *takāful* participants’ unilateral in-the-money options to extend the contractual termination date should be included. The current estimate should allow for the expected rate of exercising such options. This boundary constraint also excludes additional voluntary contributions, except where provided for as a unilateral option under the contract. For *takāful* contracts with variable contributions (such as universal family *takāful* contracts), the cash flows should include voluntary contributions above the minimum required, to the extent that there are guarantees, under the current contract – for example, no-lapse and contribution rate guarantees. The current estimate should reflect the expected rate of payment of additional contributions and the expected level of such contributions.

14.8.6 The second boundary constraint clarifies that future cash flows arising from events beyond the point where the TO can unilaterally cancel the contract – for example, by re-underwriting – are not included in the valuation. This is the case with most general *takāful* contracts which are typically written for only one year. Although there might be a high expectation that they would be renewed, the TO is not bound to do so, and accordingly only cash flows arising in respect of the currently in-force or in run-off contracts are included for valuation purposes, whereas the impact of new business might be considered in capital requirements or capital resources by the solvency

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¹⁷ For certain types of long-duration family *takāful* contracts, these would be evaluated through the potential life of the participants, allowing for lapse or surrender in the probabilities attached to each cash flow.
regime. By contrast, future cash flows under a family takāful or disability contract which the TO cannot unilaterally cancel should be included, even if the future contributions under such a contract are planned to increase, or able to be varied by the TO in respect of the entire class of contracts without individual underwriting.

14.8.7 The third boundary constraint clarifies that even if the takāful participant has an option to continue or increase the contract, if it requires the TO’s consent then cash flows arising from events beyond that point should not be included for valuation purposes, whereas the impact of new business might be considered in capital requirements or capital resources by the solvency regime.

Discretionary Payments

14.8.8 Discretionary payments, although familiar in some types of conventional insurance, are not typically a feature of takāful. When establishing the future cash flows to include in the determination of technical provisions for solvency purposes, consideration should nonetheless be given to all payments whether or not they are contractually required.

14.8.9 In many jurisdictions, accumulated surplus attributable to a class of takāful participants is accounted for separately by the TU. Where such accumulated surplus can be used to absorb losses to protect takāful participant interests in a period of stress, it may possess all the characteristics of capital and may hence be recognised in the determination of capital resources for solvency purposes. In such a case, it is important to ensure that the criteria established by the solvency regime for the allowance of future discretionary benefits in the valuation of technical provisions are compatible with the criteria for determining capital resources in order to achieve a consistent overall assessment of the solvency position of the TU.

14.8.10 Capital adequacy is determined on a forward-looking basis. When capital adequacy is being determined, it may be foreseeable that amounts that have been recognised as surplus will in fact be paid out in the near future rather than being retained in the TU as capital (e.g. if it is already expected that they will be distributed to takāful participants or be applied for charitable purposes). Where this is the case, the amount of the foreseeable payment should be excluded from eligible capital resources for solvency purposes (if it has not been taken into account in the determination of technical provisions or recognised as another liability for regulatory purposes). Similarly, any amount to be paid out (but not yet paid) in purification of income determined to be tainted should be excluded from capital resources, either by recognising it as a liability for regulatory purposes or by deducting it from capital resources once they have been initially determined.

Unbiased Current Assumptions
Unbiased current assumptions are derived from a combination of relevant, credible experience as well as judgment about its expected future development – for example, improving mortality rates, or inflation of expenses – that neither deliberately overstates nor understates the expected outcome. Reconsideration of data and assumptions should occur every time the technical provisions are valued, with revisions made as appropriate to ensure data and assumptions remain appropriate to current conditions.

Observable data, such as discount rates, financial market prices and inflation rates, may be expected to be different each time the current estimate is determined. In particular, cash flows are sensitive to inflation rates. Where assumptions are derived from observed values in the market, these should be the observed values current at the date of the valuation.

Regular experience analysis, considering the individual entity and relevant industry experience where appropriate, should be undertaken to support the assumptions used for takāful technical risks. Where assumptions depend on the results of such experience analyses, the most recent experience for the portfolio need not necessarily represent the most credible current assumption for that portfolio. Greater credibility may be achieved by the analysis of several years’ experience, smoothing out fluctuations in experience and allowing appropriately for any trends in experience that may be evident. However, care should also be taken that historical experience remains relevant to current conditions.

Where the credibility of a TU’s own experience is low – for example, for a small or new portfolio of takāful contracts – assumptions based on the relevant industry experience are likely to be more decision useful as a basis for projecting its cash flows.

The assumptions used should, in principle, reflect the characteristics of the portfolio rather than those of the particular TU holding that portfolio. However, it is important to note that, in practice, the characteristics of the portfolio underwritten by a TU may reflect aspects of a TO’s specific business practices, particularly with regard to its underwriting, claims handling and expenses. Company-specific information may be appropriate, for example, where the TU’s or TO’s business model and practices are sufficiently substantiated as representative of the portfolio and similar information is used in market valuations.

With respect to expenses, the TU’s own expense experience in managing a portfolio is likely to be relevant in determining an economic value. Expense experience should be considered in both the takāful funds and the SHF. Where the SHF bears expense risk, that fund should recognise appropriate technical provisions for future outflows associated with the settlement of claims or administration of policies in force.

Acquisition costs are typically a major component of a TU’s expenses. For most takāful contracts, acquisition costs will already have been incurred so
that future cash flows include only maintenance and claims costs. An appropriate analysis of the TU’s expense experience is needed to separate out acquisition costs in order to model future expenses. Care is needed to allow for expenses that do not vary directly with the level of new business so that expenses that will continue to be incurred for a period if new business ceases are taken into account.

14.9 The MOCE reflects the inherent uncertainty related to all relevant future cash flows that arise in fulfilling *takāful* obligations over the full time horizon thereof.

14.9.1 Different methods may be used in practice to measure risk. For some risks, observable market prices for risk may be available. In choosing a methodology, due consideration should be given to the nature of the risks being measured. Other approaches being considered around the world include quantile, conditional tail expectation, cost of capital and explicit assumption methods. Where a mixture of appropriate methods is used, a consistency check should be considered. Calibration of the methods used should reduce the effect of methodological differences to a level sufficient to enable reliable solvency assessment to be undertaken. At present, there is no one common methodology. In practice, the results from different methods will not be identical and calibration and consistency checks should be applied so that methodological differences are reduced to an acceptable level for solvency assessment purposes. Once established, the methodology should not be changed from one valuation to the next unless there is a reasonable rationale for change.

14.9.2 The MOCE represents an estimated measure of the uncertainty inherent in the cash flows associated with fulfilling a TU’s obligations under *takāful* contracts it has entered into. To achieve a consistent, reliable and decision-useful valuation, the MOCE should consider all of the inherent uncertainty attached to the policy obligations over the full period of those obligations – that is, the variability of all relevant future cash flows to the extent to which this uncertainty is borne by the TU (whether the collective *takāful* fund or the SHF) and not the *takāful* participant.

14.9.3 Only risk inherent to the *takāful* obligations should be reflected in the MOCE. Other risks should be reflected in regulatory capital requirements. Where risks are reflected in both the MOCE and regulatory capital requirements to provide an overall level of safety, double counting should be avoided as far as practical.

14.9.4 In some jurisdictions it may be considered appropriate, due to inherent uncertainty in *takāful* obligations and surplus (or, in the case of the SHF, profit), that no component of *takāful* contribution related to such considerations should be recognised in surplus (or profit) at the inception of a contract. In those jurisdictions, the inherent uncertainty is effectively represented by the difference between contribution received and the current estimate. Other jurisdictions may take the view that one of the other methodologies described in this document provides a decision-useful
separate estimate of the level of uncertainty in determining the MOCE and may therefore allow potential gain at issue to be recognised.

14.9.5 It is important to be clear about the extent to which risk factors should be reflected when valuing the MOCE. It is appropriate to differentiate between the risks specific to the portfolio of takāful obligations and the risks associated with the operations of the particular TU. Risks that are portfolio specific are inherent to the policy obligations and should be taken into account in the MOCE.

14.9.6 In determining the appropriate methodology for determining the MOCE in a solvency regime, the supervisor should consider the extent to which possible methodologies promote transparency and comparability between TUs and takāful markets.

14.9.7 An appropriate method for determining the MOCE would be expected to exhibit the following characteristics:
- Takāful obligations with similar risk profiles have similar MOCEs.
- The less that is known about the cash flows, the higher the MOCE.
- For the same level of probability, risks with higher impact have higher MOCEs than those with lower impact.
- Risks with low frequency and high severity will generally have higher MOCEs than risks with high frequency and low severity.
- For risks of the same or a similar nature, contracts that persist over a longer time frame will have higher MOCEs than those of shorter duration.
- Risks with a wide probability distribution have higher MOCEs than those risks with a narrower distribution.
- To the extent that emerging experience reduces uncertainty, MOCEs should decrease, and vice versa.

14.9.8 In establishing appropriate criteria or methods for determining the MOCE, the supervisor should consider the diversification of the inherent risk factors reflected in the MOCE.

14.9.9 Consideration should be given to the segmentation of the takāful policies of the TU into separate portfolios and the impact this has on the diversification of inherent risk factors that is taken into account. Segmentation – for example, by line of business – may be undertaken for calculation purposes and may mean that diversification within portfolios is taken into account in the MOCE but diversification across portfolios is left out of account. The calculation method may also mean that diversification within portfolios is only partially taken into account. Any residual diversification within portfolios and all diversification across portfolios could, for example, be addressed as an offset to regulatory capital requirements, if appropriate. The MOCEs for the total business of the TU would simply be the sum of the MOCEs of its portfolios.
14.9.10 Where an element of a takāful liability – that is, a takāful obligation or risk in whole or in part – can be replicated by a financial instrument which has a reliable value, the value of that instrument provides a reliable value for that element of the liability, including an implicit MOCE. In practice, there are often some differences between the takāful cash flows and those of the replicating instrument which need to be valued separately. Where a model is used for this valuation, calibration of the model to the value of the covering instrument used is likely to assist in achieving overall consistency and reliability. Such a practice should be encouraged by supervisors.

14.10 The valuation of technical provisions allows for time preference. The supervisor establishes criteria for the determination of appropriate rates to be used in the discounting of technical provisions.

14.10.1 The solvency regime allows for time preference to be recognised in the determination of technical provisions and should establish criteria for the determination of appropriate discount rates to be used in the discounting of technical provisions. In developing these criteria, the supervisor should consider the following:

• the economics of the takāful obligations in its jurisdiction, including their nature, structure and term; and
• the extent (if any) to which entitlements are dependent on underlying assets.

14.10.2 The criteria for determining appropriate discount rates to be used in the discounting of technical provisions should recognise that the appropriate discount rates may not be directly observable and apply adjustments based on observable economic and market data of a general nature as appropriate.

14.10.3 To the extent that a risk is provided for elsewhere in the balance sheet by alternative means, there should be no allowance for that risk in the chosen discount rates.

14.10.4 As the discount rates should reflect the economics of the takāful obligations, any observed yield curve should be adjusted to account for differences between the economics of the observed instrument and those of the takāful obligations.

14.10.5 The criteria should also allow appropriate interpolation and extrapolation for non-observable market data and maturities. To provide for consistent, reliable, economic values, the criteria for discount rates should utilise the entire term structure for time preference.

14.10.6 In principle, if an investment has a reliable market value and fully replicates or covers an element of the takāful obligations or risks, such a value is presumed to reflect time preference.

14.11 The supervisor requires the valuation of technical provisions to make appropriate allowance for embedded options and other features.
14.11.1 The determination of the current estimate and MOCE should make explicit allowance for any options of the takāful participant or TO and for any other features for the benefit of the takāful participant that are embedded in the takāful contract, such as guaranteed minimum entitlements and earnings. The method used to value embedded options and other features should be appropriate to the nature, scale and complexity of risk and may include stochastic simulation or simplified methods as appropriate.

14.11.2 An important option for takāful participants is the option to lapse and, for some family takāful products, to receive payment of a surrender value. Explicit allowance for lapses and surrenders should be incorporated in the projections of future cash flows that are used to determine technical provisions. The risks of lapse and surrender need to be considered over the full time horizon of the takāful contract. Historical experience of lapses and surrenders is decision useful in considering the setting of assumptions about future experience used for calculating a current estimate and MOCE. The uncertainty associated with lapses and surrender may not be fully diversifiable across takāful contracts as the level of lapses and surrenders may depend on economic conditions or perceptions about the performance of the TU which apply generally to takāful participants. This is offset by variations in takāful participants’ responses to such conditions or perceptions and their personal motivation for lapse and surrender. Such factors should be taken into account when assessing the risk of lapse and surrender.

14.11.3 Technical provisions are not required to be subject to a surrender value floor equal to the total surrender values payable if all takāful contracts were to surrender immediately. Such an approach would not be an economic valuation as the effect of surrenders is already allowed for in the technical provisions by incorporating assumptions about the future rate of surrender and associated risks. However, in the determination of the overall financial requirements for solvency assessment purposes, a form of surrender value minimum may be considered appropriate, to provide additional protection in the event of a high level of surrenders. This should be reflected in regulatory capital requirements, as appropriate.

TCP 15: INVESTMENTS
The supervisor establishes regulatory investment requirements for solvency purposes in order for TUs to make appropriate investments taking account of the risks they face.

Introductory Guidance

15.0.1 A defining feature of the takāful sector is that its operations are held out to be Shari‘ah-compliant. Although few supervisors are charged with the enforcement (still less the determination) of Shari‘ah compliance, Shari‘ah non-compliance risk in TOs is a risk, in both prudential and conduct terms,
of which the supervisor must be aware. Sharīʿah compliance is relevant to
the investment activities of TUs.

15.0.2 In addition to regulatory investment requirements that would typically apply
to all forms of insurance (e.g. security, availability and diversification), TUs
operate under the constraint that investment activities should be
undertaken on a Sharīʿah-compliant basis. Investment activities are within
the scope of the Sharīʿah governance framework described in TCP 8: Sharīʿah Governance.

15.0.3 Islamic investing has much in common with concepts of ethical investment
familiar in conventional financial services. This includes making
investment-related decisions on the basis of social, religious or
environmental considerations. Thus, investments having certain forms or
characteristics, or in particular types of business, are prohibited or
discouraged, in favour of others that are viewed more positively from this
perspective.

15.0.4 Sharīʿah compliance may also lead to a requirement for a TU to forfeit (by
way of purification) income identified as tainted by impermissible activities.

15.0.5 The Sharīʿah-compliance status of an investment may alter over time, for
various reasons. As examples, the fatwā originally permitting the
investment might be modified by disregarding it or issuing a replacement
fatwā with different effect. The TU’s non-compliant investments might also
exceed its tolerated threshold of non-compliant investment.

15.0.6 The investment objectives and policies of the TO (including for investments
attributable to takāful participants) reflect the additional consideration of
Sharīʿah compliance. The design and monitoring of those objectives and
policies, and their implementation (ex ante and ex post), is subject to
scrutiny under the TO’s Sharīʿah governance framework.

15.0.7 In view of the additional consideration aforementioned, supervisors seek
where possible to avoid imposing requirements that could force TUs into
Sharīʿah non-compliance.

Basis for Establishing Regulatory Investment Requirements

15.1 The supervisor establishes regulatory investment requirements on
the investment activities of the TU.

15.1.1 The nature of takāful business necessitates the investment in and holding
of assets sufficient to cover technical provisions and capital requirements.
The quality and characteristics of a TU’s asset portfolio and the
interdependence between the TU’s assets and its liabilities are central to
an assessment of a TU’s solvency position and, therefore, are important
aspects to be addressed by the supervisor and for a TU to manage.
15.1.2 Quantitative requirements alone are not sufficient to ensure solvency, but should also be complemented with appropriate qualitative requirements on investment risk. Having both kinds of requirements helps to guard against the possibility that the regulatory capital requirements do not fully cover the risks inherent in those investment activities.

15.1.3 Factors to consider in establishing regulatory investment requirements may include:

• the overall quality of risk management practices and corporate governance frameworks of TOs;
• the comprehensiveness and transparency of disclosure frameworks in the jurisdiction and the ability for third parties to exercise sufficient scrutiny and market discipline;
• the development of relevant investment and capital markets locally and internationally and the range of available financial instruments;
• the cost of compliance, the impact on innovation and the effect on the efficiency of industry practices; and
• the level of prudence and risk sensitivity of the regulatory solvency requirements and the risks that they cover.

15.1.4 In considering the range of available financial instruments, the supervisor has regard to the restricted ability of TUs to avail themselves of investments that do not comply with Sharīʻah or fall within an approved justification for departure.

15.1.5 Additionally, the supervisor should consider requirements applied in other, non-takāful, financial sectors when establishing regulatory investment requirements for TUs. It is important that requirements across financial sectors are as consistent as possible in order to discourage groups from taking advantage of regulatory arbitrage. Consistency of regulation between sectors may assist in maintaining a level playing field and enhancing fairness. However, such requirements should take into account the differences in risk profiles and risk management between sectors.

15.1.6 In this regard, supervisors should be aware that conventional financial services enterprises are not subject to the obligation of Sharīʻah compliance, and their frameworks may not reflect such an obligation. Restrictions applied in Islamic financial services other than takāful may be taken into account by supervisors when making decisions as to the restrictions that should be applied to the takāful sector, provided always that differences in risk profile and risk management are acknowledged.

15.1.7 Openness and transparency of the regulatory investment requirements may help facilitate their effectiveness. The supervisor should be explicit as to the objectives of setting regulatory investment requirements. This is particularly important in order to ensure the consistency of such requirements with other building blocks of the regulatory solvency assessment of the TU, such as the valuation of assets and liabilities, the calculation of regulatory capital requirements and the determination of available capital resources.
**Rules-Based and Principles-Based Approaches**

15.1.8 Regulatory investment requirements may take many forms and may influence the investment strategies of the TU. Requirements may be rules-based, setting out specific rules or restrictions on the investment activities of the TU; or principles-based, where there is no specific restriction on the asset strategy taken by the TU, as long as defined principles are met.

15.1.9 Regulatory investment requirements may also be a combination of rules-based and principles-based, setting out some specific rules or restrictions and some principles with which the TU’s investment strategy should comply.

15.1.10 Rules-based requirements may be used to prohibit or limit specific classes of investment. Such rules or restrictions may either be applied directly to the investments or lead to capital charges or deductions from available capital which act as a disincentive to investment in risky assets or high concentrations in particular assets, rather than as a prohibition.

15.1.11 Rules-based requirements may be relatively easy to enforce by supervisors, as there is limited scope for different interpretations of the rules. However, rules-based requirements may inhibit innovation in investment strategies and may restrain TUs from holding assets most appropriate for meeting their financial objectives. Rules-based requirements may also discourage TUs from fully developing their own risk management.

15.1.12 Principles-based requirements may provide more flexibility for the TU to choose particular investments to best manage its investment risks. It may allow the TU to follow an investment strategy that it believes is the most appropriate to its risk appetite and overall financial objectives. However, it may also be more difficult for the supervisor to determine the need to take supervisory measures as principles-based investment requirements allow some scope for differences in interpretation.

**Group Perspectives**

15.1.13 In addition to meeting the qualitative and quantitative investment requirements at a takāful legal entity level, the insurance group should monitor investment risk exposures on an aggregate basis for the group as a whole.

15.1.14 For insurance groups, regulatory investment requirements may specify how investment exposures should be aggregated for the purposes of determining investment risk at a group level. Such requirements should provide for appropriate mitigation of risks associated with intra-group transactions – for example, to limit contagion or reputational risk. Issues to be considered may include exposures to related counterparties and other interests over which the TU has some influence (e.g. through a minority
interest). In stress situations there will tend to be greater restrictions on movements and realisation of investments across the group. The regulatory investment regime may require contractual evidence of the ability to access assets for solvency purposes before allowing their inclusion for aggregation at the group level.

15.1.15 The regulatory investment requirements that apply at the takāful legal entity and group levels, as well as the objectives of such requirements, should be explicit. Such requirements should include issues specific to groups, such as requirements for liquidity, transferability of assets and fungibility of capital within the group.

15.1.16 The supervisor of a takāful legal entity in the group should contribute to discussion of group-level requirements, noting the possibility that a TU’s surplus includes segregated fund surplus that is not transferable within the group (e.g. because it is attributable to takāful participants in that fund).

15.1.17 Regulatory investment requirements should be set having regard to the possibility of losses from investments made by entities of an insurance group weakening another entity or the group as a whole (e.g. if there is explicit or implicit support from another entity).

Regulatory Investment Requirements Regarding the Asset Portfolio

15.2 The supervisor requires the TU to invest assets so that, for its portfolio as a whole:

• assets are sufficiently secure and are held in the appropriate location for their availability;
• payments to takāful participants or creditors can be made as they fall due; and
• assets are adequately diversified.

Introductory Guidance

15.2.1 In Islamic insurance, these regulatory requirements will operate in conjunction with the obligation of the TO to invest only in assets that demonstrate Shari‘ah compliance (or fall within an approved justification). While in some jurisdictions the supervisor may have the mandate to enforce Shari‘ah compliance, in others Shari‘ah compliance is viewed by the supervisor principally as a governance obligation of the TO, though it is also relevant to prudential and conduct supervision where incidents of Shari‘ah non-compliance could result in consumer detriment or financial instability of the TO. Accordingly, the supervisor requires the TO to have effective governance in place to mitigate Shari‘ah non-compliance risks.

15.2.2 The assessment of Shari‘ah non-compliance risk may be particularly difficult in the case of investments such as indirect investments through a collective investment fund or for investments in complex financial instruments such as structured assets. In such cases, the TO needs the
capacity and availability of the necessary information to assess the Sharīʻah-non-compliance risks in the funds, both at their establishment and on an ongoing basis.

15.2.3 Where segregation of funds is practised, qualitative investment requirements are applied at the level of the fund. Whereas within a unitary entity the different levels of security, location, risk profile and maturity in the investment portfolio may diversify, this is not the case if the TU consists of several segregated funds, each with its own needs for security and liquidity and without the ability to call on other funds for temporary assistance. In this case, diversification is confined to the level of the individual funds.

15.2.4 There are Sharī‘ah issues around the use of derivatives as normally understood, and the guidance in this TCP therefore refers to the use of hedging mechanisms, which can be Sharī‘ah-compliant,¹⁸ to hedge investment risks arising in takāful operations. In the event that a TU is permitted to make use of derivatives, the unmodified guidance of ICP 15 should be followed in respect of those instruments.

Security

15.2.5 The TU’s investments should be sufficiently secure for the portfolio as a whole, which is essential in ensuring obligations to takāful participants can be met. Regulatory investment requirements may restrict the TU’s selection of, or exposure to, investments that have low security or whose security is difficult to assess reliably. There should be appropriate measures in place to recognise and mitigate aggregations of exposure across the TU’s portfolio, having particular regard to concentrations of low-security assets or those whose security is difficult to assess reliably.

15.2.6 The security of an investment is related to the protection of its value and can be affected by credit risk and market risks (including currency risk). The security of an investment is also affected by safekeeping, custodianship or trusteeship. Assets should be held in an appropriate location so they are available to meet takāful participant claims where takāful participant payments are made.

15.2.7 External credit ratings can assist the TU in determining the credit risk of an investment. However, the TU should be aware of the limits of using external credit ratings and conduct its own due diligence to assess credit risk. The supervisor may establish requirements for the appropriate use of external credit ratings. The supervisor may also require the TU to conduct

¹⁸ For detailed analysis of Sharī‘ah-compliant and non-Sharī‘ah-compliant hedging mechanisms, refer to OIC Fiqh Academy Resolution no. 238 (9/24) regarding hedging mechanisms in Islamic financial institutions, and to AAOIFI Sharī‘ah standard no. 45: Protection of Capital and Investments.
a credit analysis independent of the external credit rating, which may help in assessing the security of an investment.

15.2.8 To assess the security of its investments, it is important that the TU is capable of assessing the nature, scale and complexity of the associated risks. This may be difficult in cases where there is a lack of transparency as to the underlying risk profile of an investment, such as indirect investments through a collective investment fund or for investments in complex financial instruments such as structured assets. Some markets may also suffer from a lack of transparency or clarity in terms of the applicable regulatory and legal systems and the degree of protection that they provide.

15.2.9 For assets lacking in transparency, the risk profile should be carefully analysed by the TU. The TU should look through to the underlying exposure of the investment as far as possible, considering the additional risks that are due to the investment structure. For example, additional legal risks may arise if investments are located outside of the TU's operating jurisdiction(s).

15.2.10 Where segregation of funds is practised, and qard is pledged (but not paid) to a fund, assessing the security of the pledged qard requires assessment of whether the lender will pay up the qard if called.

15.2.11 The TO should evaluate the security of hedging mechanisms by taking into account the underlying exposures, as well as the security of the hedge counterparty, the purpose for which the hedge arrangement is held, and the cover (such as collateral) the TO has for hedge exposures. In some cases, hedge counterparties may improve the security by giving the TO the right to collateral if the counterparty fails. Similarly, the security of investments may be improved by guarantees from third parties.

15.2.12 When engaging in securities lending or repurchase agreements, a TU should consider counterparty risk and reinvestment risk. The TU should ensure the transactions are appropriately collateralised (with suitably frequent updating) and should recognise that these transactions do not mitigate the market or credit risk in the security, since the security is returned to the TU at the end of the transaction. Care should be taken by the TU when investing the collateral it holds to ensure that the transactions are covered even under adverse market conditions.

**Security – Group Perspectives**

15.2.13 The supervisor should consider the possibility that aggregation of exposures in an insurance group may result in heightened security issues which may be less important at the takāful legal entity level. The supervisor should closely monitor a group investing in assets that are not secure, and which could be distributed around the group to avoid investment restrictions.
Liquidity

15.2.14 The TU should have assets that generate sufficient cash flows to pay takāful participant claims when due, as well as all other obligations. The cash generated from investments includes disposals, maturity, and coupon or dividend payments.

15.2.15 The ability of the TU (or a segregated fund within a TU) to remain liquid may be adversely impacted for a variety of reasons. For example, the TU or fund:
- pledges or hypothecates its assets (including, in the case of a fund, to another segregated fund in the same TU);
- experiences an unexpectedly large claim;
- experiences an event resulting in many claims;
- experiences significant shifts in market conditions; or
- has a hedging arrangement that needs to be serviced (e.g. due to collateralisation or posting of margins).

15.2.16 The ability to realise or liquidate a sufficient amount of investments to meet takāful participant claims, as well as all other obligations, at any point in time is important. For example, where an investment is made in a closed fund, a resale is usually not possible. This would impede the security of the investment in terms of its ability to settle obligations towards takāful participants. Similar considerations would need to be given for property used by the TU which might be hard to liquidate without an operational disruption.

Liquidity – Group Perspectives

15.2.17 The TU and group-wide and other involved supervisors should consider the nature of the potential legal and practical impediments to cross-border transfer of assets as well as any potential effect those impediments might have, particularly in a resolution.

15.2.18 Group issues are relevant when managing liquidity risk, both in terms of the availability of additional liquidity and the possible need to provide liquidity support to other parts of the group.

15.2.19 Entities within a group frequently engage in intra-group transactions (e.g. swaps, intercompany loans) in order to manage risks that exist in different parts of the group or to have more mature businesses support growing businesses within the group. Such transactions should be done using appropriate transfer pricing based on current market conditions so that there is appropriate recognition of the impact of these transactions for each of the entities involved and the group as a whole.

15.2.20 Liquidity of assets and fungibility of capital are especially important if the group relies on diversification between entities without each entity being fully capitalised on a stand-alone basis (where allowed by the supervisor).
The TUs should consider their liquidity needs, transferability of assets and fungibility of their capital in a stressed environment when determining the minimum criteria for liquidity of their investment portfolio.

15.2.21 Fungibility of capital and ability to transfer assets may be constrained by obligations on a TU to maintain Sharī‘ah compliance, potentially meaning that capital otherwise apparently available cannot be transferred to (or from) the TU.

Diversification

15.2.22 Diversification and pooling of risks is central to the functioning of takāful business. To mitigate the risk of adverse financial events, it is important that the TU’s overall investment portfolio is adequately diversified and that its asset and counterparty exposures are kept to prudent levels.

15.2.23 Where takāful is conducted on the basis of segregation of funds, diversification applies at the level of the fund. Asset risks, like takāful risks, are shared among the takāful participants in the fund, and cannot then be diversified against asset risks in the SHF or in other takāful funds. However, where one fund (usually, the SHF) provides support to another, the risk of aggregation of risks needs to be given particular consideration, as segregation does not necessarily protect against a risk simultaneously crystallising in multiple funds.

15.2.24 There is a distinction between diversification within a risk category and diversification between risk categories. Diversification within a risk category occurs where risks of the same type are pooled (e.g. shares relating to different companies). Diversification between risk categories is achieved through pooling different types of risk. For example, where the TU combines two asset portfolios whose performances are not fully correlated, the exposure to the aggregated risks will generally be lower than the sum of the exposures to the risks in the individual portfolios.

15.2.25 With respect to its investment portfolio, the TU should ensure that it is diversified within and between risk categories, taking into account the nature of the liabilities. Diversification between investment risk categories could, for example, be achieved through spreading the investments across different classes of assets and different markets. For diversification within a risk category, the investments are sufficiently uncorrelated so that – through pooling of individual assets – there is a sufficient degree of diversification of the portfolio as a whole.

15.2.26 To ensure that its investment portfolio is adequately diversified, the TU should avoid overreliance on, for example, any specific asset type, issuer, counterparty, group or market, and any excessive concentration or accumulation of risk in the portfolio as a whole. The TU may also consider its asset concentration by type of investment product, by geographical dispersion or by credit rating. Additionally, the TU may consider its aggregate exposure to related entities (such as joint ventures) and different
types of exposure to the same entity or group (such as equity investment in an RTU which is also providing its retakāful cover).

**Diversification – Group Perspectives**

15.2.27 Having risk management processes to monitor investments on a group-wide basis is more likely to make senior management aware of issues (e.g. asset concentrations) that could be overlooked if only the individual legal entities are monitored. Groups that are unaware of their global exposures could face an inappropriate level of exposure to certain investments, which may create financial difficulties within the group if the value or liquidity of these investments decreases.

**Group Perspectives**

15.2.28 The assets of an entity within an insurance group may include participations or investments in another entity within the same group. Appropriate investment requirements should apply to such investments or participations, particularly due to liquidity concerns. Relatively small holdings in another legal entity within the same insurance group that does not give the investor control over the TU may, for example, be subject to the same requirements that apply to investments in entities external to the group. On the other hand, for larger holdings which give the investor control or significant influence over the issuer, consideration should be given to aggregating the assets of the TU with those of the investor for the purposes of applying investment requirements. This is done so that adequate security, liquidity and diversification are maintained and that the investor, using its control over the issuer, ensures the issuer’s investment activities are consistent with its own investment policy.

**Regulatory Investment Requirements Relating to the Nature of the Liabilities**

15.3 The supervisor requires the TO to invest in a manner that is appropriate to the nature and duration of its liabilities.

15.3.1 Assets that are held to cover takāful participants’ liabilities and those covering regulatory capital requirements should be invested in a manner which is appropriate to the nature of the liabilities, as the TU needs to use the proceeds of its investments to make payments to takāful participants and other creditors when due. The TU’s investment strategies should take into account the extent to which the cash flows from investments match the liability cash flows in terms of timing, amount and currency, and how this changes in varying conditions. In this context, the TU should specifically consider investment guarantees and embedded options that are contained in its takāful policies.

15.3.2 TUs are not necessarily required to employ an investment strategy which matches the assets and the liabilities as closely as possible. However, to the extent that assets and liabilities are not well matched, movements in financial variables (e.g. profit rates, market values and exchange rates)
may affect the value of the assets and the liabilities differently and result in an adverse economic impact for the TU.

15.3.3 As liability cash flows are often uncertain, or there are not always assets with appropriate cash flow characteristics, the TU is usually not able to adopt a completely matched position. Additionally, the TU may wish to adopt a mismatched position deliberately in an attempt to optimise the return on its business. In such circumstances, the supervisor may require the TU to hold additional technical provisions and/or capital to cover the mismatching risk. The regulatory investment requirements may also constrain a TU’s ability to mismatch its assets and liabilities as the extent of mismatching should not expose takāful participants to risks that cannot be effectively managed by the TO.

15.3.4 Nevertheless, close matching of assets and liabilities is often possible and should be considered as a potential requirement in the case of unit-linked or universal life policies where there is a direct link between takāful participants’ benefits and investment funds or indices. It may not be possible for the mismatching risk to be covered effectively by capital. Where the supervisor requires assets to be closely matched to such liabilities, other restrictions on investments may be appropriate to contain the investment fund risk being borne directly by takāful participants.

15.3.5 The TU should manage conflicts of interest (e.g. between the TO’s corporate objectives and disclosed takāful policy objectives) to ensure assets are invested appropriately. For example, for with-profits liabilities, a TO should invest appropriately to meet takāful participants’ reasonable expectations.

15.3.6 Where segregation of funds is practised, the appropriateness of investments is assessed at the level of the fund. The TO is responsible for managing conflicts of interest between itself and the takāful fund, and for addressing the respective objectives and liabilities of each fund separately. Where the SHF earmarks assets to be transferred as qard if required, the assessment of appropriateness in the hands of the recipient fund extends to those assets.

Group Perspectives

15.3.7 Investments that back liabilities, including those covering regulatory capital requirements within one of a group’s insurance legal entities, should be tailored to the characteristics of the liabilities and the needs of the TU and not be subject to undue influence from the wider objectives of the group.

Regulatory Investment Requirements Regarding Risk Assessability

15.4 The supervisor requires the TU to invest only in assets where it can properly assess and manage the risks.
15.4.1 The TO should have sufficient information about its investments, including those in collective investment funds, to ensure that its asset risks can be properly managed.

15.4.2 The TO should understand the risks involved, and determine how material the risk from a proposed investment is, before undertaking any investments. Assessment of risks should take into account the maximum possible loss, including losses that may occur in situations where assets, such as derivatives, become liabilities for the TU.

15.4.3 Where the TO is able to look through the structure of the investments to the underlying assets, the TO should consider the risk characteristics of the underlying assets and how this affects the risk characteristics of the investments itself. However, where such a look through is not possible, appropriate techniques should be developed to assess the risks associated with the investment, including assessing the investment manager of an investment fund.

15.4.4 Investments that are not traded on a regulated financial market should be kept to prudent levels, as an objective assessment of the risks is likely to be difficult and costly. This is particularly relevant in jurisdictions where standardised approaches to determining regulatory capital requirements are used, since such approaches will often be designed to be not unduly complex and thus feasible in practice for all TUs. Moreover, by its very nature a standardised approach may not be able to fully and appropriately reflect the risk profile of the investment portfolio of each individual TU.

15.4.5 The TO should have access to the requisite knowledge and skills to assess and manage the risks of its investments. When an external investment adviser or manager is used, the TO should retain adequate investment expertise in-house, as it has the ultimate responsibility for its investments.

15.4.6 Investments held by entities within a group are sometimes managed centrally by an investment management function, with the entities relying on its expertise. In such arrangements, the investment management function should have the requisite knowledge and skills to assess and manage the risks of these investments and manage the investments with due regard to the needs of individual entities in addition to the group as a whole. To the extent that assets of a TU, or of a segregated fund of a TU, are included in the assets managed by a group investment management function, the TO is responsible for ensuring that its specific requirements are considered, including that of effective Sharī‘ah governance.

Regulatory Investment Requirements Relating to Specific Financial Instruments

15.5 The supervisor establishes quantitative and qualitative requirements, where appropriate, on:

• the use of more complex and less transparent classes of assets; and
• investments in markets or instruments that are subject to less governance or regulation.
15.5.1 Complex investments may have a higher risk of large, sudden or unexpected losses due to the nature of the underlying risks and volatilities. Similarly, there are some assets in which investment is permitted by the regulatory investment regime (because the risk is generally sufficiently assessable), but are less transparent compared to other investments. Other assets could be less well governed in terms of the systems and controls in place for managing them or the market regulation that applies to them. Such assets may present operational risks, particularly in adverse conditions that are difficult to assess reliably. In terms of market regulation, investments in an unregulated market or a market that is subject to less regulation (such as the Professional Securities Market of the London Stock Exchange) need to be given special consideration.

15.5.2 The supervisor should therefore establish quantitative or qualitative requirements or restrictions on such investments, as necessary. For example, regulatory investment requirements may include the pre-approval of a TU’s hedging arrangement use plan, whereby the TO has to describe its controls over and testing of the hedging investment process before it is used in a live environment.

15.5.3 The investments described below are examples of investments that may necessitate quantitative and qualitative requirements; however, this is not an exhaustive list and regulatory investment requirements should be flexible and/or sufficiently broad to take account of the changing environment. The solvency position and the sophistication of a TU should also be considered. The amount of available capital a TU has could provide additional flexibility to the supervisor in particular cases.

**Off-Balance Sheet Structures**

15.5.4 When deciding whether to invest in off-balance sheet structures, the TO should take into account their unique characteristics and risk exposures. For example, special purpose entities (SPEs) (see TCP 13: Retakāful and Other Forms of Risk Sharing) are generally more complex than other forms of investments.

15.5.5 An investment strategy that uses an off-balance sheet structure may have an impact on the ability of the TU to pay *takāful* participant claims and all other obligations, especially under stressed circumstances.

**Investments in Structured Credit Products**

15.5.6 A TU may have opportunities to invest in securities or other financial instruments which have been packaged by an SPE and which may originate from other financial institutions (including banks or conventional insurers). Examples of such instruments are asset-backed securities (ABS), credit-linked notes (CLN) or conventional insurance-linked securities (ILS). In these cases, even where such investment is assessed to be compatible with Shari‘ah, it may be very difficult for the TU to assess
the risk inherent in the investment, and in particular the risk profile of the underlying reference instruments, which in some cases may be of particularly poor quality (e.g. sub-prime mortgages). Where the originator is a conventional insurer, the investment may also carry takāful-correlated risks (such as non-life catastrophe risks in the case of a non-life catastrophe bond securitisation) which may not be transparent to the TU or else difficult to assess.

15.5.7 The ability of a TU to invest in such structures may be constrained by its obligation to maintain Shari‘ah compliance, as well as the need to assess the impact on each segregated fund (where segregation is practised) and to ensure that the arrangement is aligned with the interest of its stakeholders.

15.5.8 If the supervisor is concerned that the TU is exposed to an undue level of risk in such cases, it may consider establishing qualitative or quantitative requirements which may relate directly to the TU investing in such assets, or which may relate to the originator of the packaged instrument.

15.5.9 In establishing such requirements, the supervisor may recognise that some structured credit products are higher in risk than others and consider, for example:
- the treatment of such investment in other financial sectors;
- the extent to which the originator has retained an interest in a proportion of the risk being distributed to the market;
- the definition and soundness of criteria applied by the originator in extending the original credit and in diversifying its credit portfolio;
- the transparency of the underlying instruments; and
- the procedures the TO has in place to monitor exposures to securitisations, including consideration of securitisation tranches, and reporting them to the TO’s board and senior management and supervisor.

15.5.10 Restrictions or prohibitions may be applied to investments in structured products where appropriate conditions are not satisfied.

Use of Hedging Arrangements and Similar Commitments

15.5.11 A TO choosing to engage in hedging activities should clearly define its objectives, ensuring that these are consistent with any supervisory requirements.

15.5.12 When used appropriately, hedge arrangements may be useful tools in the management of portfolio risk of TUs and in efficient portfolio management. In monitoring the activities of TUs involved in hedging arrangements, the supervisor should satisfy itself that the TO has the ability to recognise, measure and prudently manage the risks associated with their use. The supervisor should obtain sufficient information on the TO’s policies and processes on the use of hedging arrangements and may request
information on the purpose for which particular hedging arrangements are to be used and the rationale for undertaking particular transactions.

15.5.13 Given the nature of takāful operations, hedging arrangements should preferably be used as a risk management mechanism rather than for speculation. The supervisor may restrict the use of hedging arrangements (particularly hedging arrangements that involve the possibility of unlimited loss) to the reduction of investment risk or efficient portfolio management. This means that where hedging arrangements are used, it is for the purpose of reducing risk and costs or generating additional capital or income with an acceptable level of risk. Restrictions may also be applied to require the suitability of hedging arrangements' counterparties, the hedging arrangements' collateral, the tradability of the hedging arrangements and, in the case of over-the-counter hedging arrangements, the ability to value and to close out the position when needed. Hedging arrangements should be considered in the context of a prudent overall asset–liability management strategy.

15.5.14 A TU’s ability to take advantage of some hedge structures may be constrained by the need for it to demonstrate Sharī‘ah compliance, as well as the need to consider each segregated fund separately if that is the model.

TCP 16: ENTERPRISE RISK MANAGEMENT FOR SOLVENCY PURPOSES

The supervisor requires the TU to establish within its risk management system an enterprise risk management framework for solvency purposes to identify, measure, report and manage the TU’s risks in an ongoing and integrated manner.

Introductory Guidance

16.0.1 Enterprise risk management (ERM) for solvency purposes is the coordination of risk management, strategic planning, capital adequacy and financial efficiency in order to enhance sound operation of the TO and ensure the adequate protection of takāful participants. Capital adequacy measures the TO’s assessment of residual risk of its business after overlaying the mitigating financial effect of the TO’s established risk management system. Any decision affecting risk management, strategic planning or capital would likely necessitate a compensating change in one or both of the other two. Successful implementation of ERM for solvency purposes results in enhanced insight into a TU’s risk profile and solvency position that promotes a TO’s risk culture, earnings stability, sustained profitability and long-term viability, as well as the TU’s ability to meet obligations to takāful participants. Collectively practised in the industry, ERM for solvency purposes supports the operation and financial condition
of the takāful sector. These aspects of ERM should therefore be encouraged from a prudential standpoint.

16.0.2 The ERM framework for solvency purposes (“ERM framework”) is an integrated set of strategies, policies and processes established by the TO for an effective implementation of ERM for solvency purposes.

16.0.3 Where segregation of funds is practised, the appropriateness of ERM for solvency purposes is assessed at the level of the fund. The TO is responsible for addressing the components of the ERM framework with respect to each fund, and for managing any conflicts of interest between itself and the stakeholders who have an interest in any of the funds that it manages.

16.0.4 Components of the ERM framework that are covered in this TCP are:
- risk identification (including group risk and relationship between risks);
- quantitative techniques to measure risk;
- interrelationship of risk appetite, risk limits and capital adequacy;
- risk appetite statement;
- asset–liability management, investment, underwriting and liquidity risk management policies;
- own risk and solvency assessment (ORSA); and
- recovery planning.

16.0.5 The ERM framework should be integrated within the TO’s risk management system (see TCP 9: Risk Management and Internal Controls).

16.0.6 The ERM framework should enhance a TO’s understanding of material risk types, their characteristics, interdependencies, and the sources of the risks, as well as their potential aggregated financial impact on the business for a holistic view of risk at enterprise level. Senior management should exhibit an understanding of the TO’s enterprise risk issues and show a willingness and ability to address those issues. A fundamental aspect of ERM is the development and execution of a consistent, transparent, deliberate and systematic approach to manage risks, both individually and in aggregate, on an ongoing basis to maintain solvency and operation within the risk appetite and risk limits. ERM should be embedded in a TO’s corporate culture to ensure that the whole organisation contributes to risk awareness, feedback loops and coordinated responses to risk management needs.

16.0.7 The objective of ERM is not to eliminate risk. Rather, it is to manage risks within a framework that includes self-imposed limits. In setting limits for risk, the TO should consider its solvency position and its risk appetite. Risk limits should be set after careful consideration of strategic objectives, business plans and circumstances, and should take into account the projected outcomes of scenarios run using a range of plausible future business assumptions which reflect sufficiently adverse scenarios. A risk
limits structure is used to establish guardrails on a TU’s risk profile to optimise its returns without endangering the ability of the TU to meet its commitments to takāful participants.

16.0.8 Some TOs may utilise internal models as part of their ERM process in order to generate sophisticated risk metrics to inform management actions and capital needs. Internal models may enhance risk management and embed risk culture in the TU. They may provide a common measurement basis across all risks (e.g. same methodology, time horizon, risk measure, level of confidence) and strengthened risk-based strategic decision making across the organisation. Such an approach typically adopts a total balance sheet approach whereby the impact of the totality of material risks is fully recognised on an economic basis. A total balance sheet approach reflects the interdependence between assets, liabilities, capital requirements and capital resources, and identifies the capital allocation sufficient to protect the TU and its takāful participants, as well as to improve capital efficiency.

16.0.9 The TO should have adequate governance and internal controls in place for models used in the ERM framework. The calculation of risk metrics should be transparent, supportable and repeatable.

16.0.10 A TO should have contingency plans that describe in advance the necessary actions and resources to limit business disruption and losses resulting from an adverse financial event (such as risk exposures exceeding risk limits) or an operational event (such as a natural disaster). Contingency planning may include a recovery plan, when deemed necessary.

Enterprise Risk Management Framework – Risk Identification

16.1 The supervisor requires the TO’s ERM framework to provide for the identification of all reasonably foreseeable and relevant material risks and risk interdependencies for risk and capital management.

Risk Identification

16.1.1 The scope of risk identification and analysis of risk interdependencies should cover, at least: takāful risk, market risk, credit risk, concentration risk, operational risk and liquidity risk. Other risks may be included, such as conduct risk, legal risk, political risk, reputational risk, strategic risk and group risk.

16.1.2 In a TU, the risk of direct or indirect losses arising from failure to comply with Shari‘ah rules and principles is a form of operational risk.

Sources of Risk and the Relationship between Risks

16.1.3 A TO should consider the sources of different risks and their impacts and assess the relationship between risk exposures. By doing so, a TO can better identify both strengths and weaknesses in governance, control
functions and business units. The TO should use and improve risk management policies, techniques and practices, and change its organisational structure to make these improvements where necessary. The TO should also assess external risk factors which, if they were to crystallise, could pose a significant threat to its business.

16.1.4 In assessing the relationship between risk exposures, consideration should be given to correlations between the tails of risk profiles. For example, risks that show no strong dependence under normal economic conditions (such as catastrophe risks and market risks) could be more correlated in a stress situation.

16.1.5 Assessments of risk exposures should consider macroeconomic exposures. For example, a TU should consider interdependencies between guarantees and options embedded in its products, the assets backing those products, financial markets and the real economy.

16.1.6 Sources of risks may include catastrophes, downgrades from rating agencies, or other events that may have an adverse impact on the TO’s financial condition and reputation. These events can result, for example, in an unexpected level of claims, collateral calls or takāful participant terminations, and may lead to serious liquidity issues. The ERM framework should adequately address the TO’s options for responding to such events.

**Group Risk**

16.1.7 Group risk is the risk that the financial condition of a group or a legal entity within the group may be adversely affected by a group-wide event, an event in a legal entity, or an event external to the group. Such an event may either be financial or non-financial (such as a restructuring).

16.1.8 Group risk may arise, for example, through contagion, leveraging, double or multiple gearing, concentrations, large exposures and complexity. Participations, loans, guarantees, risk mitigation measures, liquidity, outsourcing arrangements and off-balance sheet exposures may all give rise to group risk. Many of these risks may be borne by stand-alone takāful operations and are not specific to being an operation that is part of a group. However, the interrelationships among operations within a group, including aspects of control, influence and interdependence, alter the impact of risks on the operations and should therefore be taken into account in managing the risks of a takāful operation within the insurance group and the risks of that insurance group as a whole.

**Group Perspectives**

16.1.9 The ERM framework of an insurance group should address the direct and indirect interrelationships between legal entities within the insurance group. The more clearly defined and understood such relationships are, the more accurately they can be allowed for in the group-wide solvency assessment. For example, legally enforceable capital and risk transfer
instruments between legal entities within a group may help with the effectiveness of its ERM framework for group-wide solvency assessment purposes. To be effective, the management of insurance group risk should take into account risks arising from all parts of an insurance group, including non-TU (regulated or unregulated) and partly owned entities.

16.1.10 Interrelationships between takāful and conventional insurance operations within the insurance group could affect Sharī‘ah compliance at the level of the TUs concerned and, under some circumstances, their solvency as a consequence. For example, income receivable by a TU from another group operation, or assets earmarked to support the capital of a TU, could be found to be tainted in Sharī‘ah compliance terms and require purification.

16.1.11 Assumptions that are implicit in the solvency assessment of a TU may not apply at an insurance group level because of separation of legal entities within the insurance group. For example, there may be few, if any, constraints on the fungibility of capital and the transferability of assets within an individual insurance legal entity. However, such constraints may feature much more prominently for an insurance group and may restrict the degree to which benefits of diversification of risks across the group can be shared among legal entities within the insurance group. Such constraints should be taken into account in both the insurance group’s and the TU’s ERM frameworks.

Enterprise Risk Management Framework – Quantitative Techniques to Measure Risk

16.2 The supervisor requires the TO’s ERM framework to:

- provide for the quantification of risk and risk interdependencies under a sufficiently wide range of techniques for risk and capital management; and
- as necessary, include the performance of stress testing to assess the resilience of its total balance sheet against macroeconomic stresses.

Measuring, Analysing and Modelling the Level of Risk

16.2.1 The level of risk is a combination of the impact that the risk will have on the TU and the probability of that risk materialising. The TO should assess regularly the level of risk it bears by using appropriate forward-looking quantitative techniques (such as risk modelling, stress testing, including reverse stress testing, and scenario analysis). An appropriate range of adverse circumstances and events should be considered, including those that pose a significant threat to the financial condition of the TU, and management actions should be identified together with the appropriate timing of those actions. Risk measurement techniques may also be used in developing long-term business and contingency plans.

16.2.2 Different approaches to measuring risk may be appropriate depending on the nature, scale and complexity of a risk and the availability of reliable
data on the behaviour of that risk. For example, a low-frequency but high-impact risk where there is limited data (such as catastrophe risk) may require a different approach from a high-frequency, low-impact risk for which there is substantial amounts of experience data available. Stochastic risk modelling may be appropriate to measure some risks (such as non-life catastrophe), whereas relatively simple calculations may be appropriate in other circumstances.

16.2.3 The measurement of risks should be based on a consistent economic assessment of the total balance sheet as appropriate to ensure that appropriate risk management actions are taken. In principle, a TO’s ERM framework should take into consideration the distribution of future cash flows to measure the level of risks. The TO should be careful not to base decisions purely on accounting or regulatory measures that involve non-economic considerations and conventions, although the constraints on cash flows that they represent should be taken into account.

Group Perspectives

16.2.4 An insurance group should clarify whether data used in risk assessments are based on a consolidated, aggregated or other method. The insurance group should take into account the implications and inherent risks of the selected methodology when developing its ERM framework. For example, intra-group transactions may be eliminated in consolidation and thus may not be reflected in the consolidated financial statement of the insurance group at the top level. In using the consolidation basis for the ERM framework, the insurance group may be able to account, and take credit, for diversification of risk. Conversely, using another aggregation method may facilitate a more granular recognition of risk.

Use of Models for ERM

16.2.5 Measurement of risks undertaken at different valuation dates should be produced on a broadly consistent basis overall, which may make variations in results easier to explain. Such analysis also aids the TO in prioritising its risk management.

16.2.6 Regardless of how sophisticated they are, models cannot exactly replicate the real world. Risks associated with the use of models (modelling and parameter risk), if not explicitly quantified, should be acknowledged and understood as the TO implements its ERM framework, including by the TO's board and senior management.

16.2.7 Models may be external or internal. External models may be used to assess catastrophes or market risks. Internal models may be developed by a TO to assess specific material risks or to assess its risks overall.

16.2.8 Internal models can play an important role in facilitating the risk management process and the supervisor should encourage TOs to make use of such models for parts or all of their business, where it is appropriate.
16.2.9 A TO may consider that the assessment of current financial resources and the calculation of regulatory capital requirements would be better achieved through the use of internal models, where permitted.

16.2.10 If used, an internal model may provide an important strategic and operational decision-making tool and should be used to enable the TO to integrate its risk and capital management processes. In particular, the internal model used for ORSA should be consistent with models for other processes within the ERM framework. These include: assessment of the risks faced within the takāful's business; construction of risk limits structure; and the determination of the economic capital needed, where appropriate, to meet those risks.

16.2.11 To be effective, an internal model should address all the identified risks within its scope, and their interdependencies, and assess their potential impact on the takāful's business given the possible situations that could occur. The methods by which this analysis could be conducted range from simple stress testing of events to more complex stochastic modelling, as appropriate.

16.2.12 The TU's internal model should be calibrated on the basis of defined modelling criteria that the TO believes will determine the level of capital appropriate and sufficient to meet its business plan and strategic objectives. These modelling criteria may include the basis for valuation of the assets and liabilities, the confidence level, risk measure and time horizon, as well as other business objectives (e.g. aiming to achieve a certain minimum investment rating).

16.2.13 In constructing its internal model, a TU should adopt risk modelling techniques and approaches that are appropriate to its risk strategy and business plans. A TU may consider various inputs to the modelling process, such as economic scenarios, asset portfolios and liabilities from in-force or past business, and regulatory constraints on the transfer of assets.

16.2.14 An internal model used to determine economic capital may enable the TO to allocate sufficient financial resources to ensure it continues to meet its takāful participant liabilities as they fall due, at a confidence level appropriate to its business objectives. To fully assess takāful participant liabilities in this way, all liabilities that should be met to avoid putting takāful participant interests at risk need to be considered, including any liabilities for which a default in payment could trigger the winding up of the TU.

16.2.15 If a TU uses its own internal model as part of its risk and capital management processes, the TO should validate it and review it on a regular basis. Validation should be carried out by suitably experienced individuals in a different department or by persons other than those who created the internal model, in order to facilitate independence. The TO may wish to consider an external review of its internal model by appropriate
specialists; for example, if the internal review cannot be performed with sufficient independence, an external review may be warranted.

16.2.16 Where a risk is not readily quantifiable (e.g. in the case of some operational risks or where there is an impact on the TO’s reputation), the TO should make a qualitative assessment that is appropriate to that risk and sufficiently detailed to be useful for risk management. The TO should analyse the controls needed to manage such risks to ensure that its risk assessments are reliable and consider events that may result in high operational costs or operational failure. Such analysis should inform the TO’s judgments in assessing the size of the risks and enhancing overall risk management.

16.2.17 It may be appropriate for internal models to be used for a group even where the use of an internal model is not an approach appropriate at the takāful legal entity level due to, for example, lack of sufficient data.

**Stress Testing, Scenario Analysis and Reverse Stress Testing**

16.2.18 Stress testing measures the financial impact of stressing one or more factors which could severely affect the TU. Scenario analysis considers the impact of a combination of circumstances to reflect historical or other scenarios which are analysed in the light of current conditions. Scenario analysis may be conducted deterministically using a range of specified scenarios, or stochastically using models to simulate many possible scenarios, to derive statistical distributions of the results.

16.2.19 Stress testing and scenario analysis should be carried out by the TO to validate and understand the limitations of its models. They may also be used to complement the use of models for risks that are difficult to model or where the use of a model may not be appropriate from a cost–benefit perspective. For example, these techniques can be used to investigate the effect of proposed management actions.

16.2.20 Scenario analysis may be particularly useful as an aid to communicate risk management issues to the board, senior management, business units and control functions. As such, scenario analysis can facilitate the integration of the TO’s ERM framework within its business operations and establish a sound risk culture.

16.2.21 Scenario analysis should include consideration of implications for Sharī‘ah compliance, with involvement of the Sharī‘ah governance function and reporting to the Sharī‘ah board.

16.2.22 Reverse stress testing may help identify scenarios that could result in failure or cause the financial position of a TU to fall below a pre-defined level. While some risk of failure is always present, such an approach may help to ensure adequate focus on the management actions that are appropriate to avoid undue risk of business failure. The focus of such reverse stress testing is on appropriate risk management actions, rather
than the assessment of its financial condition, and so may be largely qualitative in nature although broad assessment of associated financial impacts may help in deciding the appropriate action to take.

16.2.23 Stress testing is intended to serve the TU as an aid to sound risk management, including by identifying residual macroeconomic exposure.

16.2.24 Macroeconomic exposure in the takāful sector can accumulate through certain types of takāful liabilities or may be created through non-takāful activities. Examples are:

- savings-oriented products (or protection-oriented products with a savings component) that offer unmatched guarantees on takāful participants’ premium payments, often combined with embedded options for takāful participants;
- products embedding features such as automatic asset sales triggered by asset value decreases or that require dynamic hedging; and
- derivatives contracts such as financial guarantee products, including credit default swaps (CDS), that are not used to hedge risk.

16.2.25 In the context of takāful, certain of these factors are less likely to be present, or may be present in forms less likely to result in accumulation of macroeconomic exposure. The constraints of Sharī‘ah will normally limit the uses that a TU makes of features or activities such as guarantees, hedging or derivatives. The supervisor takes the constraints of Sharī‘ah, informed by its own observations, into account when assessing the nature, scale and complexity of a TU's activities for the purposes set out in the following paragraph.

16.2.26 In deciding whether it is necessary to require stress testing, and the frequency, scope and type of such stress testing, the supervisor should take into account, for example:

- the nature, scale and complexity of the TU, its activities, business model and products, including the characteristics of the guarantees it provides;
- the characteristics of any automatic asset reallocation mechanisms;
- the use of dynamic hedging and the extent to which such guarantees are matched or hedged; and
- its activity in derivatives markets.

Group Perspectives

16.2.27 The risks identified and the techniques that are appropriate and adequate for measuring them (including stress testing, scenario analysis, risk modelling and reverse stress testing) may differ at the insurance group and the takāful legal entity level. Where a takāful legal entity's ERM framework is an integral part of the insurance group's ERM framework, the techniques used to measure risks at the group level should consider those that are appropriate and adequate at the takāful legal entity level.
Enterprise Risk Management Framework – Interrelationship of Risk Appetite, Risk Limits and Capital Adequacy

16.3 The supervisor requires the TU’s ERM framework to reflect the relationship between the TU’s risk appetite, risk limits, regulatory capital requirements, economic capital and the processes and methods for monitoring risk.

16.3.1 A TU’s ERM framework should reflect how its risk management coordinates with strategic planning and its management of capital (regulatory capital requirement and economic capital).

16.3.2 As an integral part of its ERM framework, a TU should also reflect how its risk management links with corporate objectives, strategy and current circumstances to maintain capital adequacy and solvency and to operate within the risk appetite and risk limits described in the risk appetite statement.

16.3.3 A TU’s ERM framework should use a reasonably long time horizon, consistent with the nature of the TU’s risks and the business planning horizon, so that it maintains relevance to the TO’s business going forward. This can be done by using methods (such as scenario models) that produce a range of outcomes based on plausible future business assumptions which reflect sufficiently adverse scenarios. The analysis of these outcomes may help the board and senior management in strategic business planning.

16.3.4 Risks should be monitored and reported to the board and senior management, in a regular and timely manner, so that they are fully aware of the TU’s risk profile and how it is evolving and make effective decisions on risk appetite and capital management.

16.3.5 Where internal models are used for business forecasting, the TO should perform back-testing, to the extent practicable, to validate the accuracy of the model over time.

16.3.6 The TU’s ERM framework should note the TU’s reinsurance arrangements and how they:
   • reflect the TU’s risk limits structure;
   • play a role in mitigating risk; and
   • impact the TU’s capital requirements.

The use of any non-traditional forms of retakāful should also be addressed.

Enterprise Risk Management Framework – Risk Appetite Statement

16.4 The supervisor requires the TU to have a risk appetite statement that:
   • articulates the aggregate level and types of risk the TU is willing to assume within its risk capacity to achieve its financial and strategic objectives, and business plan;
• takes into account all relevant and material categories of risk and their interdependencies within the TU’s current and target risk profiles; and
• is operationalised in its business strategy and day-to-day operations through a more granular risk limits structure.

16.4.1 A TU’s risk appetite statement should include qualitative statements as well as quantitative measures expressed relative to earnings, capital, risk measures, liquidity and other relevant measures as appropriate.

16.4.2 Qualitative statements should:
• complement quantitative measures;
• set the overall tone for the TO’s approach to risk taking; and
• articulate clearly the motivations for taking on or avoiding certain types of risks, products, jurisdictional/regional exposures, or other categories.

16.4.3 Risk appetite may not necessarily be expressed in a single document. However, the way it is expressed should provide the TO’s board with a coherent and holistic, yet concise and easily understood, view of the TU’s risk appetite.

16.4.4 The supervisor should require risk capacity of the TU to include the consideration of regulatory capital requirements, economic capital, liquidity and operational environment.

16.4.5 The risk appetite statement should give clear guidance to operational management on the level of risk to which the TO is prepared to be exposed and the limits of risk to which they are able to expose the TU. It should also be communicated across and within the TU to facilitate entrenching the risk appetite into the TU’s risk culture.

16.4.6 A TO should consider how to embed these limits in its ongoing operations. This may be achieved by expressing limits in a way that can be measured and monitored as part of ongoing operations. Stress testing may provide a TO with a tool to help ascertain whether the limits are suitable for its business.

Group Perspectives

16.4.7 A takāful legal entity’s risk appetite statement should define risk limits taking into account all of the group risks it faces to the extent that they are relevant and material to the takāful legal entity.

16.4.8 When creating a risk limits structure at the takāful legal entity level, the entity’s board and senior management should take into account risk limits at the group level.

Asset–Liability Management, Investment, Underwriting and Liquidity Risk Management Policies
The supervisor requires the TU’s ERM framework to include an explicit asset–liability management (ALM) policy which specifies the nature, role and extent of ALM activities and their relationship with product development, pricing functions and investment management.

16.5.1 As appropriate, the ALM policy should set out how:
• the investment and liability strategies allow for the interaction between assets and liabilities;
• the liability cash flows will be met by the cash inflows; and
• the economic valuation of assets and liabilities will change under a range of different scenarios.

ALM does not imply that assets should be matched as closely as possible to liabilities, but rather that mismatches are effectively managed. Not all ALM needs to use complex techniques. For example, simple, low-risk or short-term business may call for less-complex ALM techniques.

16.5.2 The TU’s ALM policy should recognise the interdependence between all of the TU’s assets and liabilities and take into account the correlation of risk between different asset classes as well as the correlations between different products and business lines, recognising that correlations may not be linear. The ALM policy should also take into account any off-balance sheet exposures that the TU may have and the contingency that risks mitigated may revert to the TU.

16.5.3 Different strategies may be appropriate for different categories of assets and liabilities. One possible approach to ALM is to identify separate homogeneous segments of liabilities and obtain investments for each segment that would be appropriate if each liability segment was a stand-alone business. Another possible approach is to manage the TU’s assets and liabilities together as a whole. The latter approach may provide greater opportunities for profit and management of risk than the former. If ALM is practised for each business segment separately, this is likely to mean that the TU may not benefit as much from the benefits of scale, hedging, diversification and retakāful.

16.5.4 However, for some types of takāful business it may not be appropriate to manage risks by combining liability segments. It may be necessary for the TU to devise separate and self-contained ALM policies for particular portfolios of assets that are ring-fenced or otherwise not freely available to cover obligations in other parts of the TU.

16.5.5 Assets and liabilities may be ring-fenced to protect takāful participants. For example, general takāful business is normally ring-fenced from family takāful business. Supervisory requirements or the TU’s ERM framework may require some liabilities to be closely matched with the supporting assets. For example, equity-linked or indexed-linked benefits may be closely matched with corresponding assets, and annuities’ cash outflows may be closely matched with cash inflows from fixed-income instruments.
16.5.6 Some liabilities may have particularly long durations, such as *takāful* for certain types of liability risks and whole-life *takāful contracts* and annuities. In these cases, assets with sufficiently long duration may not be available to match the liabilities, introducing a significant reinvestment risk, such that the present value of future net liability cash flows is particularly sensitive to changes in profit rates. There may also be gaps in the asset durations available. An ALM policy should address the risks arising from duration or other mismatches (e.g. by holding adequate capital or having appropriate risk mitigation in place). The ERM framework should reflect the TU's capacity to bear ALM risk, according to the TU's risk appetite and risk limits structure.

*Group Perspectives*

16.5.7 The group-wide ALM policy should take into account any legal restrictions that may apply to the treatment of assets and liabilities within the jurisdictions in which the group operates.

16.6 The supervisor requires the TU's ERM framework to include an explicit investment policy that:

- addresses investment risk according to the TU's risk appetite and risk limits structure;
- specifies the nature, role and extent of the TU's investment activities and how the TU complies with regulatory investment requirements;
- establishes explicit risk management procedures with regard to more complex and less transparent classes of assets and investments in markets or instruments that are subject to less governance or regulation; and
- as necessary, includes a counterparty risk appetite statement.

16.6.1 An investment policy may set out the TU's strategy for optimising investment returns and specify asset allocation strategies and authorities for investment activities and how these are related to the ALM policy.

16.6.2 The investment policy should address the safekeeping of assets, including custodial arrangements, and the conditions under which investments may be pledged or lent.

16.6.3 Credit risk should be considered in the investment policy.

16.6.4 The investment policy should consider excessive asset concentration based on certain characteristics, including:
- type of asset;
- credit rating;
- issuer/counterparty or related entities of an issuer/counterparty;
- financial market;
- sector; and
- geographic area.
16.6.5 It is important for the TU to understand the source, type and amount of investment risk. For example, it is important to understand who has the ultimate legal risk or basis risk in a complex chain of transactions. Similar questions arise where the investment is via external funds, especially when such funds are not transparent.

16.6.6 A number of factors may shape the TU's investment strategy. For TUs in many jurisdictions, concentration risk arising from the limited availability of suitable domestic investment vehicles may be an issue. By contrast, international TUs' investment strategies may be complex because of a need to manage or match assets and liabilities in a number of currencies and different markets. In addition, the need for liquidity resulting from potential large-scale payments may further complicate a TU's investment strategy.

16.6.7 Where appropriate, the investment policy should outline how the TU deals with inherently complex financial instruments. The need for Sharī‘ah compliance in takāful may preclude or limit the use of some forms of instrument commonly associated with the conventional insurance sector, such as derivatives, hybrid instruments that embed derivatives, private equity, hedge funds, insurance-linked instruments and commitments transacted through special purpose entities. Complex or less-transparent assets may still present operational risks in TUs that are difficult to assess reliably, especially in adverse conditions.

16.6.8 An effective investment policy and ERM framework should provide for appropriately robust models reflecting relevant risks of complex investment activities (including underwriting guarantees for such complex securities). There should be explicit procedures to evaluate non-standard risks associated with complex structured products, especially new forms of concentration risk that may not be obvious.

16.6.9 For complex investment strategies, the TU's investment policy and ERM framework may incorporate the use of stress testing and contingency planning to handle hard-to-model risks such as liquidity and sudden market movements. Trial operation of procedures may also be appropriate in advance of “live” operation.

16.6.10 The TU's investment policy and ERM framework should be clear about the purpose of using derivatives and address whether it is appropriate for it to prohibit or restrict the use of some types of derivatives where, for example:

- the potential exposure cannot be reliably measured;
- closing out of a derivative is difficult considering the illiquidity of the market;
- the derivative is not readily marketable, as may be the case with over-the-counter instruments;
- independent (i.e. external) verification of pricing is not available;
- collateral arrangements do not fully cover the exposure to the counterparty;
- the counterparty is not suitably creditworthy; and
the exposure to any one counterparty exceeds a specified amount.

These factors are particularly important for unregulated over-the-counter derivatives. The effectiveness of clearing facilities available may be a relevant consideration in assessing the counterparty risk associated with some types of over-the-counter derivatives, such as credit default swaps.

16.6.11 A counterparty risk appetite statement sets out the level of risk the TU is willing to accept that a counterparty will be unable to meet its obligations as they fall due. This may impact the TU's financial position through, for example, reductions in fair value or impairment of investments, loss of retakāful cover, open market exposures or the loss of securities that have been loaned.

16.6.12 In deciding whether it is necessary to require a counterparty risk appetite statement, the supervisor should take into account the size of the TU's counterparty exposures, both in absolute terms and relative to the TU's portfolio, according to the characteristics outlined in Guidance paragraph 16.6.4, as well as the complexity and form of these exposures. Particular attention should be paid to financial sector counterparties, as these counterparties may be more likely to contribute to the build-up of systemic risk. Attention should also be paid to off-balance sheet exposures or commitments, as these may be more likely to materialise during stress.

16.7 The supervisor requires the TU’s ERM framework to include an underwriting policy that addresses the:
• TU’s underwriting risk according to the TU’s risk appetite and risk limits structure;
• nature of risks to be underwritten, including any material relationship with macroeconomic conditions; and
• interaction of the underwriting strategy with the TU's retakāful strategy and pricing.

16.7.1 An underwriting policy should cover the underwriting process, pricing, claims settlement and expense control (where applicable and relevant to the expenses of the underwriting process). Such a policy may include:
• the terms on which contracts are written and any exclusions;
• the procedures and conditions that need to be satisfied for risks to be accepted;
• additional premiums for substandard risks; and
• procedures and conditions that need to be satisfied for claims to be paid.

16.7.2 Control of expenses associated with underwriting and payment of claims is an important part of managing risk, especially in conditions of high general rates of inflation. Inflation of claim amounts also tends to be high in such conditions for some types of risk. TOs should have systems in place to control their expenses. These expenses should be monitored by the TO on an ongoing basis.
16.7.3 The underwriting policy should take into account the effectiveness of risk mitigation. This includes ensuring that:
- the TU’s retakāful programme provides coverage appropriate to its level of capital, the profile of the risks it underwrites, its business strategy and risk appetite; and
- the risk will not revert to the TU in adverse circumstances.

16.7.4 In addressing the nature and amount of risks to be underwritten, the underwriting policy should cover at least:
- the product classes the TU is willing to write;
- relevant exposure limits (e.g. geographical, counterparty, economic sector); and
- a process for setting underwriting limits.

16.7.5 The underwriting policy should address the potential impact on the TU’s financial position from material correlations between macroeconomic conditions and the takāful portfolio (e.g. by assessing the potential impact stemming from certain takāful products with embedded guarantees and options).

16.7.6 The underwriting policy should address:
- how a TU analyses emerging risks in the underwritten portfolio; and
- how emerging risks are considered in modifying underwriting practices.

16.7.7 The underwriting policy should describe interactions with the retakāful strategy and associated credit risk, and should include details of the retakāful cover of certain product classes or particular risks.

16.8 The supervisor requires the TU’s ERM framework to address liquidity risk and to contain strategies, policies and processes to maintain adequate liquidity to meet its liabilities as they fall due in normal and stressed conditions.

16.8.1 When analysing its liquidity profile, the TO should assess the liquidity of both its assets and liabilities. The TO should consider, where applicable, issues such as:
- market liquidity in normal and stressed conditions, quality of assets and its ability to monetise assets in each situation;
- characteristics of takāful contracts that may affect takāful participant behaviour around lapse, withdrawal or renewal;
- adverse takāful events that may trigger short-term liquidity needs, including catastrophes;
- non-takāful activities, such as margining or posting collateral for derivatives contracts, securities lending or repurchase agreements; and
- contingent sources of liquidity (including committed lines of credit or future premium income) and whether these would be available in stressed conditions.
16.8.2 A TO should have well-defined processes and metrics in place, which may be simple or more advanced depending on its activities, to assess its liquidity position at different time horizons on a regular basis. A TU’s liquidity analysis should cover both normal and stressed market conditions. The TO should assess the results of such analysis in light of its risk appetite.

16.8.3 Upon the supervisor's request, the TO should report its liquidity risk management processes and analysis, including key assumptions or metrics.

*Group Perspectives*

16.8.4 An insurance group’s assessment should result in a coherent view of liquidity risk across legal entities within the group. For example, where an individual legal entity relies on the head of the group for funding, this should be accounted for in both the individual legal entity’s and the head of the group’s liquidity analysis.

16.8.5 When analysing its liquidity position, an insurance group may use different scenarios and analyses on a legal entity level and group-wide level where appropriate. Such scenarios should take into account that circumstances may differ between individual legal entities and the group as a whole.

16.9 The supervisor requires, as necessary, the TO to establish more detailed liquidity risk management processes, as part of its ERM framework, that include:

- liquidity stress testing;
- maintenance of a portfolio of unencumbered highly liquid assets in appropriate locations;
- a contingency funding plan; and
- the submission of a liquidity risk management report to the supervisor.

16.9.1 Liquidity risk increases as the imbalance between liquidity sources and needs grows – for instance, due to liquidity transformation. Unexpected liquidity needs could be generated by, for example:

- derivatives, particularly any collateral or margin that needs to be posted for mark-to-market declines in the value of the contract;
- securities financing transactions, including repurchase agreements and securities lending;
- *takāful* products that contain provisions that allow a *takāful* participant to withdraw cash from the policy with little notice or penalty; and
- *takāful* products covering natural catastrophes.

These activities may contribute to systemic risk when not properly managed – for instance, when funds received from short-term securities lending or repurchase agreements or balances from more liquid *takāful* products are invested in illiquid assets.
Some TOs are required to establish more detailed liquidity risk management processes as compared to those processes set out in Standard 16.8. More detailed liquidity risk management processes are intended to help the TO with its risk management. Additionally, the measures may provide the supervisor with a view on vulnerabilities that may cause funding shortfalls in stress.

Liquidity stress testing is a forward-looking risk management tool to reveal vulnerabilities in the TU's liquidity profile and provide information on its ability to meet liabilities as they fall due. A portfolio of unencumbered highly liquid assets may provide a source of liquidity for the TU to meet its liabilities as they fall due. A contingency funding plan, describing the strategies for addressing liquidity shortfalls in stress situations, may assist the TO in addressing an unforeseen stress situation, where its liquid assets are insufficient or unexpectedly become illiquid. A liquidity management report could assist the TO and the supervisor to address shortcomings in the TU's risk management by laying out details of its liquidity risk management in an accessible format.

In deciding whether it is necessary to require more detailed liquidity risk management processes, and the intensity of such processes, the supervisor should take into account the nature, scale and complexity of the TU's activities that lead to increased liquidity risk exposure as well as the risk amplification effects related to the size of the TU. Increased liquidity risk exposure may depend on, for example, the magnitude of potential collateral or margin calls from derivatives or other transactions, the use of securities financing transactions or the characteristics of takāful contracts that may affect takāful participant behaviour around lapse, withdrawal or renewal.

The supervisor may increase or decrease the intensity of these requirements by, for example, varying the frequency, scope and granularity of liquidity stress testing, the proportion of various types of highly liquid assets allowed in the portfolio, or the form and level of detail in the contingency funding plan and liquidity risk management report.

Where a TO is required to establish more detailed liquidity risk management processes, the supervisor should assess the effectiveness of their implementation, including the interaction with existing control mechanisms. Additionally, the supervisor should evaluate the quality and quantity of the assets that the TU includes in its portfolio of highly liquid assets in light of the liquidity characteristics of its activities. The supervisor may develop its own, general, criteria for highly liquid assets.

**Own Risk and Solvency Assessment (ORSA)**

The supervisor requires the TO to perform regularly its own ORSA for the TU to assess the adequacy of its risk management and current, and likely future, solvency position.
16.10.1 The TO should document the main outcomes, rationale, calculations and action plans arising from its ORSA.

16.10.2 ORSAs should be largely driven by how a TU is structured and how the TO manages it. The performance of an ORSA at the takāful legal entity level does not exempt the group from conducting a group-wide ORSA.

16.11 The supervisor requires the TO’s board and senior management to be responsible for the ORSA.

16.11.1 The board should adopt a rigorous process for setting, approving and overseeing the effective implementation by senior management of the TO’s ORSA.

16.11.2 Where appropriate, the effectiveness of the ORSA should be validated through internal or external independent overall review by a suitably experienced individual.

16.12 The supervisor requires the TO’s ORSA to:

- encompass all reasonably foreseeable and relevant material risks, including, at least, insurance, credit, market, concentration, operational and liquidity risks and (if applicable) group risk; and
- identify the relationship between risk management and the level and quality of financial resources needed and available;

and, as necessary:

- assess the TU’s resilience against severe but plausible macroeconomic stresses through scenario analysis or stress testing; and
- assess aggregate counterparty exposures and analyse the effect of stress events on material counterparty exposures through scenario analysis or stress testing.

16.12.1 The TO should consider in its ORSA all material risks that may have an impact on its ability to meet its obligations to takāful participants, including in that assessment a consideration of the impact of future changes in economic conditions or other external factors. The TO should undertake an ORSA on a regular basis so that it continues to provide relevant information for its management and decision-making processes. The TO should regularly reassess the sources of risk and the extent to which particular risks are material. Significant changes in the risk profile of the TU should prompt it to undertake a new ORSA. Risk assessment should be done in conjunction with consideration of the effectiveness of applicable controls to mitigate the risks.

16.12.2 The ORSA should explicitly state which risks are quantifiable and which are non-quantifiable.
In a TU, risks relating to Sharī‘ah compliance are a form of operational risk. In an ORSA, the TO should consider the risk not only that Sharī‘ah non-compliance occurs against the current framework, and the economic and non-economic implications of such an occurrence, but also the risk that the understanding of Sharī‘ah applied in the legal entity, or in the jurisdiction, develops such as to require changes to the way in which the business operates.

In deciding whether it is necessary to require scenario analysis or stress testing as part of the ORSA, and the frequency, scope and type of such scenario analysis or stress testing, the supervisor should take into account, for example, the nature, scale and complexity of the TU, its business model and products and the size of the TU’s exposures, both in absolute terms and relative to the TU’s portfolio. For macroeconomic exposure, relevant factors may include the characteristics of the guarantees the TU provides and the extent to which such guarantees are matched or hedged, the characteristics of any (automatic) asset reallocation mechanisms, the use of dynamic hedging, the TU’s activity in derivatives markets, or other drivers of volatility in the sources or uses of cash. For counterparty exposure, particular attention should be paid to financial sector counterparties, as these may be more likely to contribute to the build-up of systemic risk, and to off-balance sheet exposures or commitments, as they may be more likely to have an impact during stress.

Group Perspectives

An insurance group’s ORSA should:

• include all reasonably foreseeable and relevant material risks arising from every legal entity within the insurance group and from the widest group of which the insurance group is part;
• take into account the fungibility of capital and the transferability of assets within the group (giving due regard to any constraints on fungibility arising from the need for TUs to comply with Sharī‘ah); and
• ensure capital is not double counted.

Similarly, a takāful legal entity’s ORSA should include all additional risks arising from the widest group to the extent that they impact the takāful legal entity.

In the takāful legal entity’s ORSA and the insurance group’s ORSA, it may be appropriate to consider scenarios in which a group splits or changes its structure in other ways. Assessment of current capital adequacy and continuity analysis should include consideration of relevant possible changes in group structure and integrity in adverse circumstances and the implications this could have for group risks, the existence of the group and the support or demands from the group to or on its TU.

Given the level of complexity at the insurance group level compared with that at a TU level, additional analysis and information is likely to be needed for the group’s ORSA in order to address comprehensively the range of
insurance group level risks. For example, it may be appropriate to apply a contagion test by using stress testing to assess the impact of difficulties in each legal entity within the insurance group on the other insurance group entities.

16.12 In conducting its group-wide ORSA, the group should be able to account for diversification in the group. Moreover, the group should be able to demonstrate how much of the diversification benefit would be maintained in a stress situation.

**ORSA – Economic and Regulatory Capital**

16.13 The supervisor requires the TO to:

- determine, as part of its ORSA for the TU, the overall financial resources it needs to manage its business given its risk appetite and business plans;
- base its risk management actions on consideration of its economic capital, regulatory capital requirements, financial resources and its ORSA; and
- assess the quality and adequacy of its capital resources to meet regulatory capital requirements and any additional capital needs.

16.13.1 It is important that a TO has regard for how risk management and capital management relate to and interact with each other. Therefore, a TO should determine the overall financial resources the TU needs, taking into account its risk appetite, risk limits structure and business plans, based on an assessment of its risks, the relationship between them and the risk mitigation in place. Where segregation of funds is practised, this determination is performed at the level of each fund. Determining economic capital may help a TO to assess how best to optimise its capital base, whether to retain or mitigate risk, and how to allow for risks in its pricing.

16.13.2 Although the amounts of economic capital and regulatory capital requirements and the methods used to determine them may differ, a TO should be aware of, and be able to analyse and explain, these differences. Such analysis helps to embed supervisory requirements into a TU’s ORSA and risk and capital management, so as to ensure that obligations to takāful participants continue to be met as they fall due.

16.13.3 As part of the ORSA, the TO should perform its own assessment of the quality and adequacy of capital resources both in the context of determining its economic capital and in demonstrating that regulatory capital requirements are met having regard to the quality criteria established by the supervisor and other factors which the TO considers relevant.

**Recapitalisation**

16.13.4 If a TU (or, where segregation of funds is practised, a constituent fund of a TU) suffers losses that are absorbed by its available capital resources, it may need to raise new capital to meet ongoing regulatory capital
requirements and to maintain its business strategies. Where fund segregation is practised, and the losses have been sustained in the risk fund, this may be achievable by means of *qard* provided by the SHF, or (where permitted) by funds set aside in the SHF and earmarked for the provision of *qard* if required. Such arrangements require sufficient capital to be available in the SHF, beyond that needed for the SHF’s own resource requirements. However, assets may not be available in the SHF for *qard* without the SHF raising further capital, or it may be the SHF itself that has suffered losses prompting the need for recapitalisation. It cannot be assumed that capital will be readily available at the time it is needed. Therefore, a TO’s own assessment of the quality of capital should also consider the issue of recapitalisation, especially the ability of capital to absorb losses on an ongoing basis and the extent to which the capital instruments or structures that the TO uses may facilitate or hinder future recapitalisation. For example, a fund with *qard* to repay will have to apply future surpluses to repaying the *qard*, rather than building its own capital resources organically, and may not be attractive to future *takāful* participants.

16.13.5 For a TO to be able to recapitalise the SHF or another fund in times of financial stress, it is critical to maintain market confidence at all times, through its solvency and capital management, investor relationships, robust governance structure/practices and fair conduct-of-business practices. Some forms of capital instrument can affect the quality of governance, as they reduce the economic interest of existing investors and weaken market discipline. A TO may, however, have less ability than a conventional insurer to issue such forms of a capital instrument, due to Shari‘ah constraints.

16.13.6 When market conditions are good, many TOs should be readily able to issue sufficient volumes of high-quality capital instruments at reasonable levels of cost. However, when market conditions are stressed, it is likely that only well-capitalised TOs, in terms of both the quality and quantity of capital resources held, will be able to issue high-quality capital instruments. Other TOs may only be able to issue limited amounts of lower-quality capital and at higher cost. Therefore, the supervisor should make sure that TOs have regard for such variations in market conditions and manage the quality and quantity of their capital resources in a forward-looking manner. In this regard, it is expected that high-quality capital instruments (such as common shares) should form the substantial part of capital resources in normal market conditions as that would enable TOs to issue capital instruments even in stressed situations. Such capital management approaches also help to address the procyclicality issues that may arise, particularly in risk-based solvency requirements.

*Group Perspectives*

16.13.7 An insurance group should determine, as part of its ORSA, the overall financial resources it needs to manage its business given its risk appetite and business plans and demonstrate that its supervisory requirements are
met. The insurance group’s risk management actions should be based on appropriate risk limits and consideration of its economic capital, regulatory capital requirements and financial resources. Economic capital should thus be determined by the insurance group as well as its TU, and appropriate risk limits and management actions should be identified for both the insurance group and the TU.

16.13.8 Key group-wide factors to be addressed in the TU’s assessment of group-wide capital resources include multiple gearing, intra-group creation of capital and reciprocal financing, leverage of the quality of capital, and fungibility of capital and free transferability of assets across group entities.

ORSA – Continuity Analysis

16.14 The supervisor requires:

• the TO, as part of its ORSA for the TU, to analyse its ability to continue in business, and the risk management and financial resources required to do so over a longer time horizon than typically used to determine regulatory capital requirements; and

• the TO’s continuity analysis to address a combination of quantitative and qualitative elements in the medium- and longer-term business strategy of the TO and include projections of the TU’s future financial position and analysis of its ability to meet future regulatory capital requirements.

Capital Planning and Forward-Looking Perspectives

16.14.1 A TO should be able to demonstrate an ability to manage its risk over the longer term under a range of plausible adverse scenarios. A TU’s capital management plans and capital projections are therefore key to its overall risk management strategy. These should allow the TU to determine how it could respond to unexpected changes in market and economic conditions, innovations in the industry, and other factors such as demographic, legal and regulatory, medical and social developments.

16.14.2 Where appropriate, the supervisor should require a TO to undertake periodic, forward-looking continuity analysis and modelling of its future financial position, including its ability to continue to meet its regulatory capital requirements in future under various conditions. TOs should ensure that the capital and cash flow projections (before and after stress) and the management actions included in their forecasts are approved at a sufficiently senior level.

16.14.3 Where segregation of funds is practised, forward-looking modelling of future financial positions at the level of the fund may provide early indicators of non-viability of a fund. TOs should consider the appropriate approach to persistent deficits or long-term dependency on qardh, at fund level.

16.14.4 In carrying out its continuity analysis, the TU should also apply reverse stress testing to identify scenarios that would be the likely cause of
business failure (e.g. where the business would become unviable or the market would lose confidence in it) and the actions necessary to manage this risk.

16.14.5 As a result of continuity analysis, the supervisor should encourage TUs to maintain contingency plans and procedures. Such plans should identify relevant countervailing measures and off-setting actions they could realistically take to restore/improve the TU’s capital adequacy or cash flow position after some future stress event and assess whether actions should be taken by the TU in advance as precautionary measures.

Projections

16.14.6 A clear distinction should be made between the assessment of the current financial position and the projections, stress testing and scenario analyses used to assess a TU’s financial condition for the purposes of strategic risk management, including maintaining solvency. The TO’s continuity analysis should help to ensure sound, effective and complete risk management processes, strategies and systems. It should also help to assess and maintain on an ongoing basis the amounts, types and distribution of financial resources needed to cover the nature and level of the risks to which the TU is or may be exposed and to enable the TO to identify and manage all reasonably foreseeable and relevant material risks. In doing so, the TO assesses the impact of possible changes in business or risk strategy on the level of economic capital needed, as well as the level of regulatory capital requirements.

16.14.7 Such continuity analysis should have a time horizon needed for effective business planning (e.g. 3 to 5 years), which is longer than typically used to determine regulatory capital requirements. It should also place greater emphasis than may be considered in regulatory requirements on new business plans and product design and pricing, including embedded guarantees and options, and the assumptions appropriate given the way in which products are sold. The TU’s current premium levels and strategy for future premium levels are a key element in its continuity analysis. In order for continuity analysis to remain meaningful, the TU should also consider changes in external factors such as possible future events including changes in the political or economic situation.

Link with Business Strategy

16.14.8 Through the use of continuity analysis a TO should be better able to link its current financial position with future business plan projections and ensure its ability to maintain its financial condition in the future. This may help the TO to further embed its ERM framework into its ongoing and future operations.

16.14.9 An internal model may also be used for the continuity analysis, allowing the TO to assess the capital consequences of strategic business decisions in respect of the TU’s risk profile. For example, the TO may decide to
reduce the TU's capital requirement through diversification by writing different types of business in order to reduce the capital that is needed to be held against such risks, potentially freeing up resources for use elsewhere. This process of capital management may enable the TO to change the TU's capital exposure as part of its long-term strategic decision making.

16.14.10 As a result of such strategic changes, the risk profile of a TU may alter, so that different risks should be assessed and quantified within its internal model. In this way, an internal model may sit within a cycle of strategic risk and capital management and provide the link between these two processes.

**Group Perspectives**

16.14.11 An insurance group should analyse its ability to continue in business and the risk management and financial resources it requires to do so. The insurance group’s analysis should consider its ability to continue to exist as an insurance group, potential changes in group structure and the ability of its legal entities to continue in business.

16.14.12 A TU’s continuity analysis should assess the ongoing support from the group, including the availability of financial support in adverse circumstances as well as the risks that may flow from the group to the TU. The TU and the insurance group should both take into account the business risks they face, including the potential impact of changes in the economic, political and regulatory environment.

16.14.13 In their continuity analysis, insurance groups should pay particular attention to whether the insurance group will have available cash flows (e.g. from surpluses released from long-term funds or dividends from other subsidiaries) and whether they will be transferable among legal entities within the group to cover any payments of interest or capital on loans, to finance new business and to meet any other anticipated liabilities as they fall due. Insurance groups should outline what management actions they would take to manage the potential cash-flow implications in stressed conditions (e.g. reducing new business or cutting dividends).

16.14.14 The insurance group’s continuity analysis should also consider the distribution of capital in the insurance group after stress and the possibility that subsidiaries within the insurance group may require recapitalisation (either due to breaches of local regulatory requirements, or to a shortfall in economic capital, or for other business reasons). The assessment should consider whether sufficient sources of surplus and transferrable capital would exist elsewhere in the insurance group and identify what management actions may need to be taken (e.g. intra-group movements of resources, other intra-group transactions or group restructuring).

16.14.15 The insurance group should also apply reverse stress testing to identify scenarios that could result in failure or cause the financial position of the
insurance group to fall below a pre-defined level and the actions necessary to manage this risk.

Recovery Planning

16.15 The supervisor requires, as necessary, TOs to evaluate in advance their specific risks and options in possible recovery scenarios.

16.15.1 The supervisor may require a TO to produce a recovery plan that identifies in advance options to restore the financial position and viability if the TU comes under severe stress (see IAIS Application Paper on Recovery Planning). In deciding whether it is necessary to require a recovery plan, and the form, content and level of detail of such recovery planning, the supervisor should take into account, for example, the TU's complexity, systemic importance, risk profile and business model. A recovery plan is intended to serve the TO as an aid to sound risk management. Additionally, if the TU comes under severe stress, a plan may serve the supervisor as valuable input to any necessary supervisory measures.

16.15.2 The supervisor should require the TO to provide the necessary information to enable the supervisor to assess the robustness and credibility of any recovery plan required. If the supervisor identifies material deficiencies in the plan, it should provide feedback and require the TO to address these deficiencies.

16.15.3 The supervisor should require the TO to review any recovery plan required on a regular basis, or when there are material changes to the TO's business, risk profile or structure, or any other change that could have a material impact on the recovery plan, and to update it when necessary.

Role of Supervision in ERM for Solvency Purposes

16.16 The supervisor undertakes reviews of the TO's ERM framework for the TU, including the ORSA. Where necessary, the supervisor requires strengthening of the TO's ERM framework, solvency assessment and capital management processes.

16.16.1 The output of a TO's ORSA for a TU should serve as an important tool in the supervisory review process by helping the supervisor to understand the risk exposure and solvency position of the TU.

16.16.2 The TO's ERM framework and risk management processes (including internal controls) are critical to solvency assessment. The supervisor should therefore assess the adequacy and soundness of a TO's framework and processes by receiving regularly the appropriate information, including the ORSA report.

16.16.3 Where segregation of funds is practised, the supervisor should pay attention to the results of forward-looking stress testing, scenario analysis
and risk modelling of future capital positions and cash flows, at the level of the fund. If the results indicate that a fund will have persistent deficits or long-term dependency on qard, the supervisor can consider the implications for the viability of the fund and require the TO to take appropriate action.

16.16.4 In assessing the soundness, appropriateness, and strengths and weaknesses of the TO’s ERM framework, the supervisor should consider questions such as:

- What are the roles and responsibilities within the ERM framework?
- Is the TU within its stated risk appetite?
- What governance has been established for the oversight of outsourced elements of the ERM framework?
- What modelling and stress testing (including reverse stress testing) is done?
- Has the model risk management been applied in the ERM framework?
- How does the TU maintain a robust risk culture that ensures active support and adjustment of the TO’s ERM framework in response to changing conditions?

16.16.5 The supervisor should review a TO’s internal controls and monitor its capital adequacy, requiring strengthening where necessary. Where internal models are used to calculate the regulatory capital requirements, particularly close interaction between the supervisor and TO is important. In these circumstances, the supervisor may consider the TU’s internal model, its inputs and outputs, and the validation processes as a source of insight into the risk exposure and solvency position of the TU.

16.16.6 The supervisor should monitor the techniques employed by the TO for risk management and capital adequacy assessment and take supervisory measures where weaknesses are identified. The supervisor should not take a one-size-fits-all approach to the TU’s risk management but, rather, base their expectations on the nature, scale and complexity of its business and risks. In order to do this, the supervisor should have sufficient and appropriate resources and capabilities. For example, the supervisor may have a risk assessment model or programme with which to assess TUs’ overall condition (e.g. risk management, capital adequacy and solvency position) and ascertain the likelihood of TUs breaching supervisory requirements. The supervisor may also prescribe minimum aspects that an ERM framework should address.

16.16.7 The supervisor should require the TO to provide appropriate information on the ERM framework and risk and solvency assessments. This should provide the supervisor with a long-term assessment of capital adequacy to aid in the assessment of TUs, as well as encourage TOs to have an effective ERM framework. This may be achieved also by the supervisor requiring or encouraging TOs to provide a solvency and financial condition report. Such a report may include information such as:
• a description of the relevant material categories of risk that the TU faces;
• the TU’s risk appetite and risk limits structure;
• the TU’s overall financial resource needs, including its economic capital and regulatory capital requirements, as well as the capital available to meet these requirements; and
• projections of how such factors will develop in future.

16.16.8 The supervisor should be flexible and apply their skills, experience and knowledge of the TO in assessing the adequacy of the risk appetite statement. The supervisor may be able to assess the quality of a particular risk appetite statement by discussing with the board and senior management how the TU’s business strategy is related to the risk appetite statement, as well as how the risk appetite had an impact on the TU’s decisions. This includes reviewing other material, such as strategy and planning documents and board reports in the context of how the board determines, implements and monitors its risk appetite so as to ensure that risk taking is aligned with the board-approved risk appetite statement.

16.16.9 The supervisor should be provided access to the material results of stress testing, scenario analysis and risk modelling, with their key underlying assumptions reported to them, and have access to other results, if requested. Where the supervisor considers that the calculations conducted by a TU should be supplemented with additional calculations, it should be able to require the TO to carry out those additional calculations. The supervisor should also consider available reverse stress tests performed by TOs where they wish to assess whether appropriate action is being taken to manage the risk of business failure.

16.16.10 While TOs should carry out stress testing, scenario analysis and risk modelling that are appropriate for their businesses, the supervisor may also develop prescribed or standard tests and require TOs to perform them when warranted. One purpose of such testing may be to improve consistency of testing among a group of similar TUs. Another purpose may be to assess the financial condition of the takāful sector and its resilience to economic, market or other stresses that apply to a number of TUs simultaneously (such as pandemics or major catastrophes). Such tests may be directed to be performed by selected TOs or all TOs. The criteria the supervisor uses for scenarios for standard tests should reflect the jurisdiction’s risk environment.

16.16.11 Forward-looking stress testing, scenario analysis and risk modelling of future capital positions and cash flows, whether provided by the TO’s own continuity analysis or in response to supervisory requirements, is a valuable tool for the supervisor in assessing the financial condition of TUs. Such testing informs the discussion between the supervisor and TOs on appropriate planning, comparing risk assessments against stress test outcomes, risk management and management actions. The supervisor should consider the dynamic position of TUs and form a high-level
assessment of whether the TU is adequately capitalised to withstand a range of standardised and bespoke stresses.

16.16.12 Where an internal model, including an economic capital model, is used in a TO’s ORSA, the supervisor should obtain an understanding of the underlying assumptions used. The supervisor should review the outputs of the internal model, at least from the following viewpoints:
- scope of risk categories of the internal model;
- the TU’s prioritisation of risks in its risk appetite; and
- the TU’s use of the outputs in making major management decisions on capital planning for meeting regulatory capital requirements.

16.16.13 By reviewing the TO’s ORSA continuity analysis, the supervisor may be able to learn about the robustness of a TU’s future financial condition and the information on which the TO bases decisions and its contingency planning. Such information should enable the supervisor to assess whether a TO should improve its ERM framework by taking additional countervailing measures and off-setting actions, either immediately, as a preventive measure, or including them in future plans. The objectives of such supervisory measures may be to reduce any projected financial inadequacies, improve cash flows and/or increase a TU’s ability to restore its capital adequacy after stress events.

16.16.14 Publicly disclosing information on risk management may improve the transparency and comparability of existing solvency requirements. There should be an appropriate balance regarding the level of information to disclose about a TU’s risk management against the level of sufficient information for external and internal stakeholders which is useful and meaningful. Therefore, the requirements for public disclosure of information on risk management, including possible disclosure of elements of a solvency and financial condition report, should be carefully considered by the supervisor taking into account the proprietary nature of the information.

16.16.15 Where a TU’s risk management and solvency assessment are not considered adequate by the supervisor, the supervisor should take appropriate measures. This could be in the form of further supervisory reporting or additional qualitative and quantitative requirements arising from the supervisor’s assessment. Additional quantitative requirements should only be applied in appropriate circumstances and be subject to a transparent supervisory framework. Otherwise, if routinely applied, such measures may undermine a consistent application of standardised approaches to regulatory capital requirements.

Group Perspectives

16.16.16 In assessing the soundness, appropriateness, and strengths and weaknesses of the group’s ERM framework, the group-wide supervisor should consider questions such as:
- How well is the group’s ERM framework tailored to the group?
• Are decisions influenced appropriately by the group’s ERM framework outputs?
• How responsive is the group’s ERM framework to changes in individual businesses and to the group structure?
• How does the framework bring into account intra-group transactions; risk mitigation; and constraints on fungibility of capital, transferability of assets, and liquidity?

16.16.17 The group-wide supervisor should review the risk management and financial condition of the insurance group. Where necessary, the group-wide supervisor should require strengthening of the insurance group’s risk management, solvency assessment and capital management processes, as appropriate to the nature, scale and complexity of risks at group level. The group-wide supervisor should inform the other involved supervisors of any action required.

16.16.18 The group-wide supervisory review and assessment of the insurance group’s ERM framework should consider the framework’s suitability as a basis for group-wide solvency assessment. The arrangements for managing conflicts of interest across an insurance group should be a particular focus in the supervisory review and assessment of an insurance group’s ERM framework.

16.16.19 The supervisory assessment of the group’s ERM framework may affect the level of capital that the insurance group is required to hold for regulatory purposes and any regulatory restrictions that are applied. For example, the group-wide supervisor may require changes to the recognition of diversification across the insurance group, the allowances made for operational risk and the allocation of capital within the insurance group.

16.16.20 Although it is not a requirement in general for a takāful legal entity or an insurance group to use internal models to carry out its ORSA, the supervisor may consider it appropriate in particular cases that the ORSA should use internal models in order to achieve a sound ERM framework. The quality of an insurance group’s ORSA is dependent on how well integrated are its internal capital models, the extent to which it takes into account constraints on fungibility of capital and its ability to model changes in its structure, the transfer of risks around the insurance group and insurance group risk mitigation. These factors should be taken into account by the group-wide supervisor in its review of the insurance group’s ORSA.

16.16.21 The supervisor may wish to specify criteria or analyses as part of the supervisory risk assessments to achieve effective supervision and consistency across insurance groups. This may, for example, include prescribed stress tests that apply to insurance groups.
TCP 17: CAPITAL ADEQUACY

The supervisor establishes capital adequacy requirements for solvency purposes so that TUs can absorb significant unforeseen losses and to provide for degrees of supervisory intervention.

Introductory Guidance

17.0.1 The setting of regulatory capital requirements and their assessment against capital resources involves a number of discrete concepts and processes, not simply determining minimum requirements for capital resources, but also the identification of capital resources to meet those requirements, and their classification where they have qualitative differences.

17.0.2 The topic of internal capital models is dealt with briefly, since, at the date of this standard, the use of such models to determine regulatory capital requirements (as opposed to their use for internal capital management purposes, which is encouraged) is very rare in the takāful sector.

17.0.3 Many TUs are members of groups, either carrying on only takāful or including both takāful and conventional insurance operations. For convenience, such groups are referred to in this standard as insurance groups. Where this is the case, capital adequacy is considered at both the level of the TU (solo level) and the level of the group (group level).¹⁹

17.0.4 This TCP does not directly apply to non-takāful entities (regulated or unregulated) within an insurance group, but it does apply to TUs and insurance groups with regard to the risks posed to them by non-takāful and non-insurance entities.

Capital Adequacy in the Context of Segregation of Funds

17.1 Where fund segregation is practised, the supervisor assesses capital adequacy at the level of the fund, with due regard to any limitations on the ability of capital resources within takāful funds and the shareholders’ fund to absorb losses in any other fund.

17.1.1 Segregation of funds, between those attributable to takāful participants and those attributable to the TO, is a key feature of the hybrid TU model to which this TCP mainly refers. Such limitations may arise from the contractual terms or from the legal framework that governs the undertaking’s operations. A TU may maintain more than one takāful fund, each segregated from the others, and from the SHF. The degree of fund segregation may differ from jurisdiction to jurisdiction, and the possibility of cross-subsidisation between funds may exist. The supervisor’s

¹⁹ At the date of this standard, few insurance groups have TUs at their heads, or otherwise require a takāful supervisor to exercise the role of group-wide supervisor.
assessment of a TU’s capital adequacy should take account of any limitation on the transferability of funds within the undertaking.

17.1.2 In the event that a TO is authorised to carry on both family and general takāful business, a takāful fund should not include both family and general takāful business unless the family business is only of a short-term nature (risk protection only). Legislation may, in any case, prohibit a TO from carrying on both family and general takāful business.20 IFSB-8: Guiding Principles on Governance for Takāful (Islamic Insurance) Undertakings requires separate treatment for provisioning and investment of family and general business, whether or not they are formally separated into different takāful funds.

17.1.3 Where funds are segregated, supervisors should operate from a presumption that capital resources within funds are not fungible between funds, unless the contrary can be demonstrated. Where capital resources are not fungible, determination of capital adequacy at the fund level should not take into account the possibility of support from other funds in the event of stress and, consequently, should not benefit from diversification of risks with other segments of the TU. Regulation should set out the cases in which the presumption of non-fungibility does not apply or is capable of rebuttal (e.g. if local regulation permits capital support from the SHF to a takāful fund, other than in the form of a formal arrangement recognised as capital resources of the takāful fund in question in accordance with Guidance paragraph 17.11.19 below).

17.1.4 It may be a matter of fact that two or more takāful funds are fungible, in which case the supervisor, once properly satisfied of that fact, may consider those funds to constitute a single fund for solvency purposes.

17.1.5 When carrying out solvency supervision at the level of a segregated fund, the supervisor assesses the quality of capital resources at the level of each fund having regard to the qualitative features set out in this TCP.

Capital Adequacy in the Context of a Total Balance Sheet Approach

17.2 The supervisor requires that a total balance sheet approach is used in the assessment of solvency to recognise the interdependence between assets, liabilities, regulatory capital requirements and capital resources, and to require that risks are appropriately recognised.

17.2.1 The overall financial position of a TU, or of a fund (including the SHF) forming a part of the TU, should be based on consistent measurement of assets and liabilities and explicit identification and consistent measurement of risks and their potential impact on all components of the balance sheet. In this context, the IFSB uses the term “total balance sheet approach” to

20 An analogous restriction is commonplace in conventional insurance.
refer to the recognition of the interdependence between assets, liabilities, regulatory capital requirements and capital resources for the TU or fund in question. A total balance sheet approach should also require that the impacts of relevant material risks on a TU’s or fund’s overall financial position are appropriately and adequately recognised.\textsuperscript{21}

17.2.2 The assessment of the financial position of a TU or fund for supervision purposes addresses the TU’s or fund’s 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.

17.2.3 Technical provisions and capital have distinct roles, requiring a clear and consistent definition of both elements. Technical provisions represent the amount that a TU or fund requires to fulfil its takāful obligations and settle all commitments to takāful participants and other beneficiaries arising over the lifetime of the portfolio.\textsuperscript{22} Supervisors should be aware that the SHF may also contain technical provisions in respect of expense provisions, and require capital resources in addition to these.\textsuperscript{23}

17.2.4 Technical provisions and regulatory capital requirements should be covered by adequate and appropriate assets, having regard to the nature and quality of those assets. To allow for the quality of assets, supervisors may consider applying restrictions or adjustments (such as quantitative limits, asset eligibility criteria or “prudential filters”) where the risks inherent in certain asset classes are not adequately covered by the regulatory capital requirements.

17.2.5 Capital resources may be regarded very broadly as the amount of the assets in excess of the amount of the liabilities. “Liabilities”, in this context, includes technical provisions and other liabilities (to the extent that these other liabilities are not treated as capital resources; for example, liabilities such as subordinated debt may, under certain circumstances, be given credit for regulatory purposes as capital – see Guidance paragraphs 17.11.8 to 17.11.17). Assets and liabilities, in this context, may include contingent assets and contingent liabilities.

17.2.6 In considering the quality of capital resources, the supervisor should have regard to their characteristics, including the extent to which the capital is available to absorb losses (including considerations of subordination and priority), the extent of the permanent and/or perpetual nature of the capital

\textsuperscript{21} It is noted that the total balance sheet approach is an overall concept rather than implying use of a particular methodology.
\textsuperscript{22} This includes costs of settling all commitments to takāful participants and other beneficiaries arising over the lifetime of the portfolio of takāful contracts, the expenses of administering the contracts, the costs of hedging, reinsurance or retakāful, and of the capital required to cover the remaining risks.
\textsuperscript{23} See Guidance paragraph 14.7.4.
and the existence of any mandatory remuneration or distribution arrangements in relation to the capital.\textsuperscript{24}

\textit{Additional Guidance for Insurance Groups and TUs that are Members of Groups}

17.2.7 The capital adequacy assessment of a TU which is a member of an insurance group needs to consider the value of any holdings the TU has in affiliates. Consideration may be given, either at the level of the TU or the insurance group, to the risks attached to this value.

17.2.8 Where the value of holdings in affiliates is included in the capital adequacy assessment and the TU is the parent of the group, group-wide capital adequacy assessment and “solo” assessment of the parent may be similar in outcome, although the detail of the approach may be different. For example, a group-wide assessment may consolidate the business of the parent and its subsidiaries and assess the capital adequacy for the combined business, while a solo assessment of the parent may consider its own business and its investments in its subsidiaries.

17.2.9 There are various possible approaches for group-wide supervision. More specifically, undertaking a capital adequacy assessment of an insurance group falls into two broad sets of approaches:

- group-level focus; and
- legal entity focus.\textsuperscript{25}

“Hybrid” or intermediate approaches which combine elements of approaches with a group and a legal entity focus may also be used.

17.2.10 The choice of approach would depend on the preconditions in a jurisdiction, the legal environment which may specify the level at which the group-wide capital requirements are set, the structure of the group and the structure of the supervisory arrangements between the supervisors.

17.2.11 To further describe and compare the various approaches to group-wide capital adequacy assessment, a two-dimensional continuum may be considered; on one axis – the organisational perspective – consideration is given to the extent to which a group is considered as a set of interdependent entities or a single integrated entity; on the other axis – the supervisory perspective – consideration is given to the relative weight of the roles of TU or insurance legal entity supervision and group-wide supervision, without implying that the latter can replace the former in any way. It is recognised that supervisors around the world have adopted approaches corresponding to many points of this continuum. The continuum may be split into four quadrants, as shown in Figure 17.1.

\textsuperscript{24} More detailed guidance on the determination of capital resources is given below.

\textsuperscript{25} It is recognised that, under some models, TUs are not necessarily single legal entities. Where a TU is not, “legal entity” is to be read as the TU.
Figure 17.1 Representation of approaches to group-wide capital adequacy assessment

<table>
<thead>
<tr>
<th>SUPERVISORY PERSPECTIVE</th>
<th>Legal Entity Focus</th>
<th>Group-Level Focus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large relative weight of group supervision with respect to local supervision</td>
<td>TU or conventional insurer capital adequacy assessed for all (relevant) legal entities taking into account group impact. The results are binding and valid for local supervisors as well as for the group supervisor</td>
<td>TU or conventional insurer capital adequacy assessed under the assumption that the group behaves as a single integrated entity. Local and group supervisors additionally define how much capital each TU or conventional insurer has to hold.</td>
</tr>
<tr>
<td>Small relative weight of group supervision with respect to local supervision</td>
<td>TU or conventional insurer capital adequacy assessed for all (relevant) legal entities taking into account group impact. These results are not binding; local supervisors apply the relevant entity capital adequacy requirements to TUs and conventional insurers.</td>
<td>TU or conventional insurer capital adequacy assessed under the assumption that the group behaves as a single integrated entity. These results are not binding; local supervisors apply relevant entity capital adequacy requirements to TUs and conventional insurers.</td>
</tr>
</tbody>
</table>

**Additional Guidance for Insurance Groups and TUs that are Members of Groups – Group-Level Focus**

17.2.12 Under a group-wide capital adequacy assessment which takes a group-level focus, the insurance group is considered primarily as a single integrated entity for which a separate assessment is made for the group as a whole on a consistent basis, including adjustments to reflect constraints on the fungibility of capital and transferability of assets among group members (and within group members, such as where fund segregation is practised). Hence, under this approach, a total balance sheet approach to solvency assessment is followed which is (implicitly or explicitly) based on the balance sheet of the insurance group as a whole. However, adjustments may be necessary appropriately to take into account risks from non-takāful and non-insurance members of the insurance group, including cross-sector regulated entities and non-regulated entities.

17.2.13 Methods used for approaches with a group-level focus may vary in the way in which group capital requirements are calculated. Either the group’s consolidated accounts may be used as a basis, or an aggregation method
may be used. The former is already adjusted for intra-group holdings and further adjustments may then need to be made to reflect the fact that the group may not behave, or be allowed to behave, as one single entity. This is particularly the case in stressed conditions, but where segregation of funds is practised it will also be necessary on a going concern basis to reflect lack of fungibility within, as well as between, entities. The latter method may sum solvency positions (i.e. the difference between capital resources and capital requirements) for each TU and conventional insurer in the group with relevant adjustments for intra-group holdings in order to measure an overall surplus or deficit at group level. Alternatively, it may sum the TU and conventional insurer capital requirements and TU and conventional insurer capital resources separately in order to measure a group capital requirement and group capital resources. Where an aggregation approach is used for a cross-border insurance group, consideration should be given to consistency of valuation and capital adequacy requirements and of their treatment of intra-group transactions.

Additional Guidance for Insurance Groups and TUs that are Members of Groups – Legal Entity Focus

17.2.14 Under a group-wide capital adequacy assessment which takes a legal entity focus, the insurance group is considered primarily as a set of interdependent legal entities. The focus is on the capital adequacy of each of the parent and the other TUs and conventional insurers in the insurance group, taking into account risks arising from relationships within the group, including those involving non-takāful and non-insurance members of the group. The regulatory capital requirements and resources of the TUs and conventional insurer in the group form a set of connected results, but no overall regulatory group capital requirement is used for regulatory purposes. This is still consistent with a total balance sheet approach, but considers the balance sheets of the individual group entities simultaneously rather than amalgamating them to a single balance sheet for the group as a whole. Methods used for approaches with a legal entity focus may vary in the extent to which there is a common basis for the solvency assessment for all group members and the associated communication and coordination needed among supervisors.

17.2.15 For TUs that are members of groups and for insurance subgroups that are part of a wider insurance or other sector group, the additional reasonably foreseeable and relevant material risks arising from being a part of the group should be taken into account in capital adequacy assessment.

Establishing Regulatory Capital Requirements

Consolidated accounts may be those used for accounting purposes or may differ (e.g. in terms of the entities included in the consolidation).
17.3 The supervisor establishes regulatory capital requirements at a sufficient level so that, in adversity, a TU’s obligations to takāful participants will continue to be met as they fall due and requires that TUs maintain capital resources to meet the regulatory capital requirements.

17.3.1 Where segregation of funds is practised, the requirement for capital adequacy, and for related activities such as the performance of ORSA, applies at the level of each fund, subject to any explicit ability to consider funds together. In the event of shortfall in any fund, remedial action should be subject to appropriate Sharī‘ah governance.

Purpose and Role of Regulatory Capital Requirements and Resources

17.3.2 A TU’s board and senior management have the responsibility to ensure that the TU has adequate and appropriate capital to support the risks it undertakes. Capital serves to reduce the likelihood of failure due to significantly adverse losses incurred by the TU over a defined period, including decreases in the value of the assets and/or increases in the obligations of the TU, and to reduce the magnitude of losses to takāful participants in the event that the TU fails.

17.3.3 Where segregation of funds is practised, fund-level capital requirements aim to ensure that there are adequate capital resources in each of the takāful funds and the SHF to support the financial obligations of that fund as they fall due.

17.3.4 From a regulatory perspective, the purpose of capital is to ensure that, in adversity, a TU’s obligations to takāful participants will continue to be met as they fall due. Regulators should establish regulatory capital requirements at the level necessary to support this objective.

17.3.5 In the context of its own ORSA, the TO would generally be expected to consider the TU’s financial position from a going concern perspective (i.e. assuming that it will carry on its business as a going concern and continue to take on new business) but may also need to consider a run-off and/or winding-up perspective (e.g. where the TU is in financial difficulty). The determination of regulatory capital requirements may also have aspects of both a going concern and a run-off or winding-up perspective. In establishing regulatory capital requirements, therefore, supervisors should consider the financial position of TUs under different scenarios of operation.

17.3.6 From a macroeconomic perspective, requiring TUs to maintain adequate and appropriate capital enhances the safety and soundness of the takāful sector and the financial system as a whole, while not increasing the cost of takāful coverage to a level that is beyond its economic value to takāful participants.

27 In this context, “run-off” refers to TUs (or funds of a TU) that are still solvent but have closed to new business and are expected to remain closed to new business.
participants or unduly inhibiting a TU’s ability to compete in the marketplace. There is a balance to be struck between the level of risk that takāful participant obligations will not be paid and the cost to takāful participants of increased contributions to cover the costs of servicing additional capital.

17.3.7 The level of capital resources that TUs need to maintain for regulatory purposes is determined by the regulatory capital requirements specified by the supervisor. A deficit of capital resources relative to capital requirements determines the additional amount of capital that is required for regulatory purposes.

17.3.8 Capital resources protect the interests of takāful participants by meeting the following two objectives. They:
  • reduce the probability of insolvency by absorbing losses on a going concern basis or in run-off; and/or
  • reduce the loss to takāful participants in the event of insolvency or winding-up.

17.3.9 The extent to which elements of capital achieve the above outcomes will vary depending on their characteristics or “quality”. For example, ordinary share capital may be viewed as achieving both of the above, whereas subordinated debt may be viewed largely as only protecting takāful participants in insolvency. Capital which achieves both of the above is sometimes termed “going concern capital”, and capital which only reduces the loss to takāful participants in insolvency is sometimes termed “wind-up capital” or “gone concern” capital. It would be expected that the former (i.e. going concern capital instruments) should form the substantial part of capital resources.

17.3.10 Where segregation of funds is practised, a takāful fund may not have capital instruments of its own (e.g. ordinary share capital is in general issued from the SHF) but any accumulated surplus retained within the fund has characteristics of capital whose quality can be assessed. Capital resources of a takāful fund may be permitted also to include loans (qard) received from the SHF, or commitments to make such qard available from the SHF. The treatment of such balances that arise only between segments of the TU is further discussed below.

17.3.11 For a TU, the management and allocation of capital resources is a fundamental part of its business planning and strategies. In this context, capital resources typically serve a broader range of objectives than those in Guidance paragraph 17.3.8. For example, a TU may use capital resources over and above the regulatory capital requirements to support future growth or to achieve a targeted credit rating.

17.3.12 It is noted that a TU’s capital management (in relation to regulatory requirements and own capital needs) should be supported and underpinned by the TO establishing and maintaining a sound enterprise risk management framework, including appropriate risk and capital
management policies, practices and procedures which are applied consistently across its organisation and are embedded in its processes. Maintaining sufficient capital resources alone is not sufficient protection for takāful participants in the absence of disciplined and effective risk management policies and processes (see TCP 16: Enterprise Risk Management for Solvency Purposes and IFSB-14: Standard on Risk Management for Takāful (Islamic Insurance) Undertakings).

Additional Guidance for Insurance Groups and TUs that are Members of Groups

17.3.13 The supervisor should require insurance groups to maintain capital resources to meet regulatory capital requirements. These requirements should take into account the non-takāful and non-insurance activities of the insurance group. For supervisors that undertake group-wide capital adequacy assessments with a group-level focus, this means maintaining insurance group capital resources to meet insurance group capital requirements for the group as a whole. For supervisors that undertake group-wide capital adequacy assessments with a legal entity focus, this means maintaining capital resources in each TU and conventional insurance legal entity based on a set of connected regulatory capital requirements for the group’s TUs and conventional insurance legal entities which fully take the relationships and interactions between these legal entities and other entities in the insurance group into account.

17.3.14 It is not the purpose of group-wide capital adequacy assessment to replace assessment of the capital adequacy of the individual TUs and conventional insurance legal entities in an insurance group. Its purpose is to require that group risks are appropriately allowed for and the capital adequacy of individual TUs and conventional insurers is not overstated – for example, as a result of multiple gearing and leverage of the quality of capital or of risks emanating from the wider group – and that the overall impact of intra-group transactions is appropriately assessed.

17.3.15 Group-wide capital adequacy assessment considers whether the amount and quality of capital resources relative to required capital is adequate and appropriate in the context of the balance of risks and opportunities that group membership brings to the group as a whole and to TUs and conventional insurance legal entities which are members of the group. The assessment should satisfy requirements relating to the structure of group-wide regulatory capital requirements and eligible capital resources and should supplement the individual capital adequacy assessments of TUs and conventional insurance legal entities in the group. It should indicate whether there are sufficient capital resources available in the group so that, in adversity, obligations to takāful participants will continue to be met as they fall due. If the assessment concludes that capital resources are inadequate or inappropriate, then corrective action may be triggered either at a group (e.g. authorised holding or parent company) level or a TU level.

17.3.16 The quantitative assessment of group-wide capital adequacy is one of a number of tools available to supervisors for group-wide supervision. If the
overall financial position of a group weakens, it may create stress for its members either directly through financial contagion and/or organisational effects or indirectly through reputational effects. Group-wide capital adequacy assessment should be used together with other supervisory tools, including in particular the capital adequacy assessment of TUs in the group. A distinction should be drawn between regulated entities (takāful, insurance and other sector) and non-regulated entities. It is necessary to understand the financial positions of both types of entities and their implications for the capital adequacy of the insurance group, but this does not necessarily imply setting regulatory capital requirements for non-regulated entities. In addition, supervisors should have regard to the complexity of intra-group relationships (between both regulated and non-regulated entities), contingent assets and liabilities and the overall quality of risk management in assessing whether the overall level of safety required by the supervisor is being achieved.

17.3.17 For TUs that are members of groups and for insurance subgroups that are part of a wider insurance or other sector group, capital requirements and capital resources should take into account all additional reasonably foreseeable and relevant material risks arising from being a part of any of the groups.

Structure of Regulatory Capital Requirements – Solvency Control Levels

17.4 The regulatory capital requirements include solvency control levels which trigger different degrees of intervention by the supervisor with an appropriate degree of urgency and require coherence between the solvency control levels established and the associated corrective action that may be at the disposal of the TO and/or the supervisor.

Solvency Control Levels in the Context of Segregation of Funds

17.4.1 Where segregation of funds is practised, solvency control levels are applied at the level of each fund. Because capital adequacy is relevant consideration for the SHF as well as for the takāful funds, this include SHF.

17.4.2 The ability of the supervisor to intervene at fund level is necessary for the protection of takāful participants whose entitlements are not adequately protected by capital resources held in different segregated funds of the TU.

Establishing Solvency Control Levels

17.4.3 The supervisor should establish control levels that trigger intervention by the supervisor in a TU’s affairs when capital resources fall below these control levels. The control level may be supported by a specific framework or by a more general framework providing the supervisor latitude of action. A supervisor’s goal in establishing control levels is to safeguard takāful participants from loss due to a TU’s inability to meet its obligations when due.
17.4.4 The solvency control levels provide triggers for action by the TO and supervisor. Hence, they should be set at a level that allows intervention at a sufficiently early stage in a TU's difficulties so that there would be a realistic prospect for the situation to be rectified in a timely manner with an appropriate degree of urgency. At the same time, the reasonableness of the control levels should be examined in relation to the nature of the corrective measures. The risk tolerance of the supervisor will influence both the level at which the solvency control levels are set and the intervention actions that are triggered.

17.4.5 When establishing solvency control levels, it is recognised that views about the level that is acceptable may differ from jurisdiction to jurisdiction and by types of business written and will reflect, among other things, the extent to which the pre-conditions for effective supervision exist within the jurisdiction and the risk tolerance of the particular supervisor. The IFSB recognises that jurisdictions will acknowledge that a certain level of insolvencies may be unavoidable and that establishing an acceptable threshold may facilitate a competitive marketplace for TUs and avoid inappropriate barriers to market entry.

17.4.6 The criteria used by the supervisor to establish solvency control levels should be transparent. This is particularly important where legal action may be taken in response to a TU violating a control level. In this case, control levels should generally be simple and readily explainable to a court when seeking enforcement of supervisory action.

17.4.7 Supervisors may need to consider different solvency control levels for different modes of operation of the TU, such as a TU in run-off or a TU operating as a going concern. These different scenarios and considerations are discussed in more detail in Guidance paragraphs 17.7.3 to 17.7.5.

17.4.8 In addition, the supervisor should consider the allowance for management discretion and future action in response to changing circumstances or particular events. In allowing for management discretion, supervisors should only recognise actions which are practical and realistic in the circumstances being considered.

17.4.9 Other considerations in establishing solvency control levels include:
   • the way in which the quality of capital resources is addressed by the supervisor;
   • the coverage of risks in the determination of technical provisions and regulatory capital requirements and the extent of the sensitivity or stress analysis underpinning those requirements;
   • the relation between different levels (e.g. the extent to which a minimum is set at a conservative level);

28 The supervisor should carefully consider the appropriateness of allowing for such management discretion in the particular case of the minimum capital requirement as defined in Standard 17.5.
• the powers of the supervisor to set and adjust solvency control levels within the regulatory framework;
• the accounting and actuarial framework that applies in the jurisdiction (in terms of the valuation basis and assumptions that may be used and their impact on the values of assets and liabilities that underpin the determination of regulatory capital requirements);
• the comprehensiveness and transparency of disclosure frameworks in the jurisdiction and the ability of markets to exercise sufficient scrutiny and to impose market discipline;
• takāful participant priority and status under the legal framework relative to other creditors in the jurisdiction;
• overall level of capitalisation in the takāful sector in the jurisdiction;
• overall quality of risk management and governance frameworks in the takāful sector in the jurisdiction;
• the development of capital markets in the jurisdiction and its impact on the ability of TOs to raise capital; and
• the balance to be struck between protecting takāful participants and the impact on the effective operation of the takāful sector and considerations around unduly onerous levels and costs of regulatory capital requirements.

Additional Guidance for Insurance Groups and TUs that are Members of Groups

17.4.10 While the general considerations in Guidance paragraphs 17.4.1 to 17.4.9 on the establishment of solvency control levels apply in a group-wide context as well as a legal entity context, the supervisory actions triggered at the group level will be likely to differ from those at the legal entity level. As a group is not a legal entity, the scope for direct supervisory action in relation to the group as a whole is more limited and action may need to be taken through coordinated action at the TU level.

17.4.11 Nevertheless, group solvency control levels are a useful tool for identifying a weakening of the financial position of a group as a whole or of particular parts of a group, which may, for example, increase contagion risk or impact reputation which may not otherwise be readily identified or assessed by supervisors of individual group entities. The resulting timely identification and mitigation of a weakening of the financial position of a group may thus address a threat to the stability of the group or its component TUs and conventional insurers.

17.4.12 Group-wide solvency control levels may trigger a process of coordination and cooperation between different supervisors of group entities which will facilitate mitigation and resolution of the impact of group-wide stresses on TUs within a group. Group-wide control levels may also provide a trigger for supervisory dialogue with the group’s management.

Structure of Regulatory Capital Requirements – Triggers for Supervisory Intervention in the Context of Legal Entity Capital Adequacy Assessment
In the context of TU or fund capital adequacy assessment, the regulatory capital requirements establish:

- a solvency control level above which the supervisor does not intervene on capital adequacy grounds. This is referred to as the prescribed capital requirement (PCR). The PCR is defined such that assets will exceed technical provisions and other liabilities with a specified level of safety over a defined time horizon; and

- a solvency control level at which, if breached, the supervisor would invoke its strongest actions, in the absence of appropriate corrective action by the TO. This is referred to as the minimum capital requirement. The MCR is subject to a minimum bound below which no TU or fund is regarded to be viable to operate effectively.

Where segregation of funds is practised, solvency control levels are applied at the level of each fund, including the SHF, for which the ability of capital resources in other funds to absorb losses in the fund in question is restricted.

A range of different intervention actions should be taken by a supervisor, depending on the event or concern that triggers the intervention. Some of these triggers will be linked to the level of a TU’s capital resources relative to the level at which regulatory capital requirements are set.

In broad terms, the highest regulatory capital requirement, the prescribed capital requirement, will be set at the level at which the supervisor would not require action to increase the capital resources held or reduce the risks undertaken by the TU (overall or, so far as concerns a fund, within that fund). However, if the capital resources were to fall below the level at which the PCR is set, the supervisor would require some action by the TO either to restore capital resources to at least the PCR level or to reduce the level of risk undertaken (and, hence, the required capital level).

The regulatory objective to require that, in adversity, a TU's obligations to takāful participants will continue to be met as they fall due will be achieved without intervention if technical provisions and other liabilities are expected to remain covered by assets over a defined period, to a specified level of safety. As such, the PCR should be determined at a level such that the TU is able to absorb the losses from adverse events that may occur over that defined period and the technical provisions remain covered at the end of the period.

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29 For discussion on fungibility, see Guidance paragraphs 17.1.3 to 17.1.4.

30 Note that this does not preclude the supervisor from intervention or requiring action by the TO for other reasons, such as weaknesses in the risk management or governance of the TO for the TU. Nor does it preclude the supervisor from intervention when the TU’s capital resources, or (where relevant) those of a segregated fund, are currently above the PCR but are expected to fall below that level in the short term. To illustrate, the supervisor may establish a trend test (a time series analysis). A sufficiently adverse trend would require some supervisory action. The trend test would support the objective of early regulatory intervention by considering the speed at which capital deterioration is developing.

31 To the extent that these liabilities are not treated as capital resources.
17.5.5 The minimum capital requirement represents the supervisory intervention point at which the supervisor would invoke its strongest actions, if further capital is not made available. Therefore, the main aim of the MCR is to provide the ultimate safety net for the protection of the interests of takāful participants.

17.5.6 These actions could include stopping the activities of the TU (altogether, or of a particular fund), withdrawal of the TO’s licence, requiring the TO to close the TU to new business and run off the portfolio, transfer its portfolio (or a part of its portfolio) to the management of another TO, arrange additional retakāful, or other specified actions. This position is different from the accounting concept of insolvency, as the MCR would be set at a level in excess of that at which the assets of the TU or fund were still expected to be sufficient to meet the TU’s obligations to existing takāful participants as they fall due. The PCR cannot be less than the MCR, and therefore the MCR may also provide the basis of a lower bound for the PCR, which may be especially appropriate in cases where the PCR is determined on the basis of a TU’s internal model approved for use in determining regulatory capital requirements by the supervisor.

17.5.7 In establishing a minimum bound on the MCR below which no TU, or no single fund, is regarded to be viable to operate effectively, the supervisor may, for example, apply a market-wide nominal floor to the regulatory capital requirements, based on the need for a TU or fund to operate with a certain minimal critical mass and consideration (concerning the TO) of what may be required to meet minimum standards of governance and risk management. Such a nominal floor might vary between lines of business or type of TU and is particularly relevant in the context of a new TU, new takāful fund or new line of business. Where a nominal floor is applied at fund level, a new fund could require initial capitalisation – for example, by waqf or qarḍ.

17.5.8 Regulatory capital requirements may include additional solvency control levels between the level at which the supervisor takes no intervention action from a capital perspective and the strongest intervention point (i.e. between the PCR and MCR levels). These control levels may be set at

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32 Note that this does not preclude such actions being taken by the supervisor for other reasons, and even if the MCR is met or exceeded.

33 The term “internal model” refers to “a risk measurement system developed by a TO to analyse its overall risk position of the TU, to quantify risks and to determine the economic capital required to meet those risks”. Internal models may also include partial models which capture a subset of the risks borne by the TU using an internally developed measurement system which is used in determining the TU’s economic capital. The IFSB is aware that TUs use a variety of terms to describe their risk and capital assessment processes, such as “economic capital model”, “risk-based capital model” or “business model”. The IFSB considers that such terms could be used interchangeably to describe the processes adopted by TOs in the management of risk and capital within their business on an economic basis. For the purposes of consistency, the term “internal model” is used throughout this standard.

34 In this context, a market-wide nominal floor may, for example, be an absolute monetary minimum amount of capital required to be held by a TU in a jurisdiction.
levels that correspond to a range of different intervention actions that may be taken by the supervisor itself or actions which the supervisor would require of the TO according to the severity or level of concern regarding adequacy of the capital held by the TU. These additional control levels may be formally established by the supervisor with explicit intervention actions linked to particular control levels. Alternatively, these additional control levels may be structured less formally, with a range of possible intervention actions available to the supervisor depending on the particular circumstances. In either case, the possible triggers and range of intervention actions should be appropriately disclosed by the supervisor.

17.5.9 Possible intervention actions include:

- measures that are intended to enable the supervisor to better assess and/or control the situation, either formally or informally, such as increased supervision activity or reporting, or requiring auditors or actuaries to undertake an independent review or extend the scope of their examinations;
- measures to address capital levels such as requesting capital and business plans for restoration of capital resources to required levels, limitations on redemption or repurchase of equity or other instruments, repayment of qard and/or dividend payments, distributions and other appropriations of surplus at the fund or the TU level;
- measures intended to protect takāful participants pending strengthening of the TU’s capital position, such as restrictions on licences, volumes of takāful contributions accepted, investments, types of business, acquisitions, and retakāful and/or conventional reinsurance arrangements;
- measures that strengthen or replace the TO’s management and/or risk management framework and overall governance processes for the TU;
- measures that reduce or mitigate risks (and, hence, required capital), such as requesting retakāful, hedging and other mechanisms; and/or
- refusing, or imposing conditions on, applications submitted for regulatory approval such as acquisitions or growth in business.

17.5.10 In establishing the respective control levels, consideration should be had for these possibilities and the scope for a TU with capital at this level to be able to increase its capital resources or to access appropriate risk mitigation tools from the market. Figure 17.2 illustrates the concept of solvency control levels in the context of establishing regulatory capital requirements.
17.5.11 The column represents the total assets of the TU (or, for individual fund assessment, the fund) valued in accordance with the valuation principles prescribed for the undertaking under national solvency requirements. Technical provisions and other liabilities (again, valued in accordance with the prescribed valuation principles, e.g. with the technical provisions including a MOCE) are covered by these assets. The excess of assets over liabilities represents the capital resources (subject to any adjustments that may be made). As the values of assets and liabilities change, the amount of capital resources also changes. The PCR is the amount of capital resources above which (as is the case in this illustration) there is no requirement for supervisory intervention. The MCR represents the level of capital resources at which the most stringent supervisory intervention is undertaken.

17.5.12 The reference to adjustments in the previous paragraph relates to the possibility of, among other things, reclassifications from liabilities into capital resources, recognition of additional items, not being assets, as capital resources, restrictions on recognition of capital resources due to tiering and deductions from capital resources for foreseeable distributions. These matters are discussed in later paragraphs.

17.5.13 Where segregation of funds is practised, the determination of capital resources and of the PCR and MCR is performed at the level of the fund, with a view to ensuring that each fund (including the shareholders’ fund) is adequately capitalised to meet its obligations and does not, except where permitted by legislation, rely upon capital resources in other funds.

17.5.14 Where each fund of a TU (including the SHF) has an established PCR and MCR, the PCR and MCR of the TU as a whole should reflect the segregation of funds. Some diversification may be recognised where capital resources of one fund can be made available to support another; however, if this is not the case the PCR and MCR of the TU as a whole
may be determined by the sum of the PCRs and MCRs, respectively, of its constituent funds.

Structure of Regulatory Capital Requirements – Triggers for Supervisory Intervention in the Context of Group-Wide Capital Adequacy Assessment

17.6 In the context of group-wide capital adequacy assessment, the regulatory capital requirements establish solvency control levels that are appropriate in the context of the approach to group-wide capital adequacy that is applied.

17.6.1 The supervisor should establish solvency control levels that are appropriate in the context of the approach that is adopted for group-wide capital adequacy assessment. The supervisor should also define the relationship between these solvency control levels and those at the TU level for TUs that are members of the group. The design of solvency control levels depends on a number of factors. These include the supervisory perspective (i.e. the relative weight placed on group-wide supervision and legal entity supervision) and the organisational perspective (i.e. the extent to which a group is considered as a set of interdependent entities or a single integrated entity). The solvency control levels are likely to vary according to the particular group and the supervisors involved (see Figure 17.1). The establishment of group-wide solvency control levels should be such as to enhance the overall supervision of the TUs in the group.

17.6.2 Having group-wide solvency control levels does not necessarily mean establishing a single regulatory capital requirement at group level. For example, under a legal entity approach, consideration of the set of capital requirements for individual entities (and interrelationships between them) may enable appropriate decisions to be taken about supervisory intervention on a group-wide basis. However, this requires the approach to be sufficiently well developed for group risks to be taken into account on a complete and consistent basis in the capital adequacy assessment of TUs and conventional insurance legal entities in a group (and, where fund segregation is practised, properly reflecting the funds on which group risks impinge). To achieve consistency for TU assessments, it may be necessary to adjust the capital requirements used for TUs so they are suitable for group-wide assessment.

17.6.3 One approach may be to establish a single group-wide PCR or a consistent set of PCRs for TUs and conventional insurance legal entities that are members of the group which, if met, would mean that no supervisory intervention at group level for capital reasons would be deemed necessary or appropriate. Such an approach may assist, for example, in achieving consistency of approach towards similar organisations with a branch structure and different group structures – for example, following a change in structure of a group. Where a single group-wide PCR is determined, it may differ from the sum of TU and conventional insurance legal entity PCRs because of group factors, including group diversification effects, group risk concentrations and intra-group transactions. Similarly, where group-wide capital adequacy assessment involves the determination of a
set of PCRs for the TUs and conventional insurance legal entities in an insurance group, these may differ from the TU and conventional insurance legal entity PCRs if group factors are reflected differently in the group capital assessment process. Differences in the level of safety established by different jurisdictions in which the group operates should be considered when establishing group-wide PCR(s).

17.6.4 The establishment of a single group-wide MCR might also be considered and may, for example, trigger supervisory intervention to restructure the control and/or capital of the group. A possible advantage of this approach is that it may encourage a group solution where an individual TU or conventional insurer is in financial difficulty and capital is sufficiently fungible and assets are transferable around the group. Alternatively, the protection provided by the supervisory power to intervene at individual entity level on breach of a TU or conventional insurance legal entity MCR may be regarded as sufficient.

17.6.5 The solvency control levels adopted in the context of group-wide capital adequacy assessment should be designed so that, together with the solvency control levels at the TU or the conventional insurance legal entity level, they represent a consistent ladder of supervisory intervention. For example, a group-wide PCR should trigger supervisory intervention before a group-wide MCR because the latter may invoke the supervisor’s strongest actions. Also, if a single group-wide PCR is used, it may be appropriate for it to have a floor equal to the sum of the legal entity MCRs of the individual entities in the insurance group. Otherwise, no supervisory intervention into the operation of the group would be required even though at least one of its member TUs or conventional insurers had breached its MCR.

17.6.6 Supervisory intervention triggered by group-wide solvency control levels should take the form of coordinated action by relevant group supervisors. This may, for example, involve increasing capital at the holding company level or strategically reducing the risk profile or increasing capital in TUs or conventional insurance legal entities within the group. Such supervisory action may be exercised via the TUs or conventional insurance legal entities within a group and, where holding companies of TUs or conventional insurers are authorised, via those holding companies. Supervisory action in response to breaches of group-wide solvency control levels should not alter the existing division of statutory responsibilities of the supervisors responsible for authorising and supervising each individual TU or conventional insurance legal entity.

Structure of Regulatory Capital Requirements – Approaches to Determining Regulatory Capital Requirements

17.7 The regulatory capital requirements are established in an open and transparent process, and the objectives of the regulatory capital requirements and the bases on which they are determined are explicit. In determining regulatory capital requirements, the supervisor allows a set of standardised and,
if appropriate, other approved more tailored approaches such as the use of (partial or full) internal models.

17.7.1 Transparency as to the regulatory capital requirements that apply is required to facilitate effective solvency assessment and supports its enhancement, comparability and convergence internationally.

17.7.2 The supervisor may develop separate approaches for the determination of different regulatory capital requirements – in particular, for the determination of the MCR and the PCR. For example, the PCR and MCR may be determined by two separate methods, or the same methods and approaches may be used but with two different levels of safety specified. In the latter case, for example, the MCR may be defined as a simple proportion of the PCR, or the MCR may be determined based on different specified target criteria to those specified for the PCR.

17.7.3 The PCR would generally be determined on a going concern basis – that is, in the context of the TU continuing its operations. On a going concern basis, a TU would be expected to continue to take on new risks during the established time horizon. Therefore, in establishing the regulatory capital level to provide an acceptable level of solvency, the potential growth in a TU’s portfolio should be considered.

17.7.4 Capital should also be capable of protecting takāful participants if the TU were to close to new business. Generally, the determination of capital on a going concern basis would not be expected to be less than would be required if it is assumed that the TU were to close to new business. However, this may not be true in all cases, since some assets may lose some or all of their value in the event of a winding-up or run-off – for example, because of a forced sale. Similarly, some liabilities may actually have an increased value if the business does not continue (e.g. claims-handling expenses). Where segregation of funds is practised, this matter must also be considered if one or more of a TU’s funds is not continuing its operations. The value of its capital and the level of its fund PCR (and, therefore, its contribution to the overall PCR of the TU) may need to be determined on a different basis that reflects its run-off nature. The impact on the capital and fund PCR of the SHF may also have to be considered if, for example, the SHF has to meet expenses for which there is no continuing wakālah fee income.

17.7.5 Usually, the MCR would be constructed taking into consideration the possibility of closure to new business. It is, however, relevant to also consider the going concern scenario in the context of establishing the level of the MCR, as a TU may continue to take on new risks up until the point at which MCR intervention is ultimately triggered (as could also be the case at the fund level where segregation of funds is practised). The supervisor should consider the appropriate relationship between the PCR and MCR, including at fund level where relevant, establishing a sufficient buffer between these two levels (including consideration of the basis on which the MCR is generated) within an appropriate continuum of solvency control.
levels, having regard for the different situations of business operation and other relevant considerations.

17.7.6 It should be emphasised that meeting the regulatory capital requirements should not be taken to imply that further financial injections will not be necessary under any circumstances in future. Such financial injections might be internal to the TU (by way of qardh or other mechanism – e.g. waqf from the SHF to a takāful fund) or external (e.g. by issue of new share capital, or supplementary calls on takāful participants).

17.7.7 Regulatory capital requirements may be determined using a range of approaches, such as standard formulae, or other approaches more tailored to the individual TU (such as partial or full internal models), which are subject to approval by the relevant supervisors. Regardless of the approach used, the principles and concepts that underpin the objectives for regulatory capital requirements described in this TCP apply, and should be applied consistently by the supervisor to the various approaches. The approach adopted for determining regulatory capital requirements should take account of the nature and materiality of the risks TUs face generally and, to the extent practicable, should also reflect the nature, scale and complexity of the risks of the particular TU.

17.7.8 Standardised approaches, in particular, should be designed to deliver capital requirements which reasonably reflect the overall risk to which TUs are exposed, while not being unduly complex. Standardised approaches may differ in level of complexity depending on the risks covered and the extent to which they are mitigated or may differ in application based on classes of business (e.g. family takāful and general takāful). Standardised approaches should be appropriate to the nature, scale and complexity of the risks that TUs face and should include approaches that are feasible in practice for TUs of all types, including small and medium-sized TUs and captives taking into account the technical capacity that TOs need to manage their businesses effectively.

17.7.9 By its very nature, a standardised approach may not be able to fully and appropriately reflect the risk profile of each individual TU. Therefore, where appropriate, a supervisor should allow the use of more tailored approaches subject to approval. In particular, where a TO has an internal model (or partial internal model) for the TU that appropriately reflects its risks and is integrated into its risk management and reporting, the supervisor should allow the use of such a model to determine more tailored regulatory capital requirements, where appropriate. The use of the internal model for this purpose would be subject to prior approval by the supervisor based on a transparent set of criteria and would need to be evaluated at regular

35 A more tailored approach which is not an internal model might include, for example, approved variations in factors contained in a standard formula or prescribed scenario tests which are appropriate for a particular TU or group of conventional insurers and TUs.

36 It is noted that the capacity for a supervisor to allow the use of internal models will need to take account of the sufficiency of resources available to the supervisor.
intervals. In particular, the supervisor would need to be satisfied that the
TO’s internal model for the TU is, and remains, appropriately calibrated
relative to the target criteria established by the supervisor (see Guidance
paragraphs 17.13.1 to 17.13.19).

17.7.10 When segregation of funds is practised, the standardised approach may
be appropriate to the circumstances of one or more funds, but not all. The
supervisor could be asked to approve a partial or full internal model to
cover only one or more funds, with the remaining funds covered by the
standardised approach.

17.7.11 The supervisor should also consider whether an internal model is suitable
to be used for the determination of the MCR. In this regard, the supervisor
should take into account the main objective of the MCR (i.e. to provide the
ultimate safety net for the protection of takāful participants) and the ability
of the MCR to be defined in a sufficiently objective and appropriate manner
to be enforceable (refer to Guidance paragraph 17.4.6).

17.8 The supervisor addresses all relevant and material categories of risk in TUs
and is explicit as to where risks are addressed, whether solely in technical
provisions or solely in regulatory capital requirements, or, if addressed in both,
the extent to which the risks are addressed in each. The supervisor is also
explicit as to how risks and their aggregation are reflected in regulatory capital
requirements.

Types of Risks to be Addressed

17.8.1 The supervisor should address all relevant and material categories of risk
– including at least underwriting risk, credit risk, market risk, operational
risk and liquidity risk. This should include any significant risk concentrations
– for example, to economic risk factors, market sectors or individual
counterparties – taking into account both direct and indirect exposures and
the potential for exposures in related areas to become more correlated
under stressed circumstances.

17.8.2 When considering operational risk, the supervisor should include Sharī‘ah
non-compliance risk as a risk to which TUs are exposed. Incidence of non-
compliance may result in identifiable loss of capital resources – for
example, by way of refund of contributions or purification of tainted income –
as well as in less measurable risks relating to reputation and public
confidence in the integrity of the TU.

Dependencies and Interrelations between Risks

17.8.3 The assessment of the overall risk that a TU is exposed to should address
the dependencies and interrelationships between risk categories (e.g.
between underwriting risk and market risk) as well as within a risk category
(e.g. equity risk). This should include an assessment of potential
reinforcing effects between different risk types as well as potential “second
order effects” – that is, indirect effects – to a TU’s exposure caused by an
adverse event or a change in economic or financial market conditions.\textsuperscript{37} It should also consider that dependencies between different risks may vary as general market conditions change and may significantly increase during periods of stress or when extreme events occur. “Wrong way risk”, which is defined as the risk that occurs when exposure to counterparties, such as financial guarantors, is adversely correlated to the credit quality of those counterparties, should also be considered as a potential source of significant loss – for example, in connection with hedging transactions. Where the determination of an overall capital requirement takes into account diversification effects between different risk types, the TO should be able to explain the allowance for these effects and ensure that it considers how dependencies may increase under stressed circumstances. Where segregation of funds is practised, no credit should be taken for diversification between non-fungible funds.

**Allowance for Risk Mitigation**

17.8.4 Any allowance for retakāful or conventional reinsurance in determining regulatory capital requirements should consider the possibility of breakdown in the effectiveness of the risk mitigation and the security of the retakāful or conventional reinsurance counterparty and any measures used to reduce the retakāful or conventional reinsurance counterparty exposure. Similar considerations would also apply for other risk mitigants – for example, hedging.

17.8.5 Where segregation of funds is practised, any allowance for risk mitigation in respect of a fund should, where that mitigation takes the form of support from another fund of the same TU, or would, where applied, result in a cost in another fund, be reflected in that other fund by the cost of providing that mitigation.

**Transparency of Recognition of Risks in Regulatory Requirements**

17.8.6 The supervisor should be explicit as to where risks are addressed, whether solely in technical provisions or solely in regulatory capital requirements, or, if addressed in both, the extent to which the risks are addressed in each. The solvency requirements should also clearly articulate how risks are reflected in regulatory capital requirements, specifying and publishing the level of safety to be applied in determining regulatory capital requirements, including the established target criteria (refer to Standard 17.9).

**Treatment of Risks that are Difficult to Quantify**

17.8.7 The IFSB recognises that some risks, such as strategic risk, reputational risk, liquidity risk and operational risk, are less readily quantifiable than the other main categories of risks. Operational risk, for example, is diverse in its composition and depends on the quality of systems and controls in

\textsuperscript{37} For example, a change in the market level of profit rates could trigger an increase of lapse rates on takāful policies.
place. The measurement of operational risk, in particular, may suffer from a lack of sufficiently uniform and robust data and well-developed valuation methods. Jurisdictions may choose to base regulatory capital requirements for these less readily quantifiable risks on some simple proxies for risk exposure and/or stress and scenario testing. For particular risks (such as liquidity risk), holding additional capital may not be the most appropriate risk mitigant and it may be more appropriate for the supervisor to require the TO to control these risks via exposure limits and/or qualitative requirements such as additional systems and controls.

17.8.8 However, the IFSB envisages that the ability to quantify some risks (such as operational risk, including Sharīʿah non-compliance risk as a component of operational risk) will improve over time as more data become available or improved valuation methods and modelling approaches are developed. Further, although it may be difficult to quantify risks, it is important that a TO nevertheless addresses all material risks in its own risk and solvency assessment for the TU.

17.9 The supervisor sets appropriate target criteria for the calculation of regulatory capital requirements which underlie the calibration of a standardised approach. Where the supervisor allows the use of approved, more tailored approaches, such as internal models, for the purpose of determining regulatory capital requirements, the target criteria underlying the calibration of the standardised approach are also used by those approaches for that purpose to require broad consistency among all TUs within the jurisdiction.

17.9.1 The level at which regulatory capital requirements are set will reflect the risk tolerance of the supervisor. Reflecting the IFSB’s principles-based approach, this TCP does not prescribe any specific methods for determining regulatory capital requirements. However, the IFSB’s view is that it is important that individual jurisdictions set appropriate target criteria (such as risk measures, confidence levels or time horizons) for their regulatory capital requirements. Further, each jurisdiction should outline clear principles for the key concepts for determining regulatory capital requirements, considering the factors that a supervisor should take into account in determining the relevant parameters as outlined in this TCP.

17.9.2 Where a supervisor allows the use of other more tailored approaches to determine regulatory capital requirements, the target criteria established should be applied consistently to those approaches. In particular, where a supervisor allows the use of internal models for the determination of regulatory capital requirements, the supervisor should apply the target criteria in approving the use of an internal model by a TO for a TU for that purpose. This should achieve broad consistency among all TUs, and a similar level of protection for all takāful participants, within the jurisdiction.

17.9.3 With regards to the choice of the risk measure and confidence level to which regulatory capital requirements are calibrated, for a segregated fund or for a TU, the IFSB notes that some supervisors have set a confidence level for regulatory purposes which is comparable with a minimum
investment grade level. Some examples have included a 99.5% value at risk (VaR) calibrated confidence level over a one-year time horizon, a 99% tail value at risk (TVaR) over one year and a 95% TVaR over the term of the takāful contract obligations.

17.9.4 With regards to the choice of an appropriate time horizon, the determination and calibration of the regulatory capital requirements needs to be based on a more precise analysis, distinguishing between:
- the period over which a shock is applied to a risk – the “shock period”;
- and
- the period over which the shock that is applied to a risk will impact the TU – the “effect horizon”.

17.9.5 For example, a one-off shift in the discount rate term structure during a shock period of one year has consequences for the discounting of the cash flows over the full term of the policy obligations (the effect horizon). A judicial opinion (e.g. on an appropriate level of compensation) in one year (the shock period) may have permanent consequences for the value of claims and hence will change the projected cash flows to be considered over the full term of the policy obligations (the effect horizon).

17.9.6 The impact on cash flows of each stress that is assumed to occur during the shock period will need to be calculated over the period for which the shock will affect the relevant cash flows (the effect horizon). In many cases, this will be the full term of the takāful contract obligations. In some cases, realistic allowance for offsetting reductions in discretionary benefits to takāful participants or other offsetting management actions may be considered, where they could and would be made and would be effective in reducing takāful contract obligations or in reducing risks in the circumstances of the stress. In essence, at the end of the shock period, capital has to be sufficient so that assets cover the technical provisions (and other liabilities) re-determined at the end of the shock period. The re-determination of the technical provisions would allow for the impact of the shock on the technical provisions over the full time horizon of the takāful contract obligations.

17.9.7 Figure 17.3 summarises key aspects relevant to the determination of regulatory capital requirements.
17.9.8 For the determination of the technical provisions of a TU (in the SHF or a takāful fund), a TO is expected to consider the uncertainty attached to the takāful contract obligations — that is, the likely (or expected) variation of future experience from what is assumed in determining the current estimate — over the full period of the takāful contract obligations. As indicated above, regulatory capital requirements should be calibrated such that assets exceed the technical provisions (and other liabilities) over a defined shock period with an appropriately high degree of safety. That is, the regulatory capital requirements should be set such that the TU’s capital resources can withstand a range of pre-defined shocks or stress scenarios that are assumed to occur during that shock period (and which lead to significant unexpected losses over and above the expected losses that are captured in the technical provisions).

Calibration and Measurement Error

17.9.9 The risk of measurement error inherent in any approach used to determine capital requirements should be considered. This is especially important where there is a lack of sufficient statistical data or market information to assess the tail of the underlying risk distribution. To mitigate model error, quantitative risk calculations should be blended with qualitative assessments and, where practicable, multiple risk measurement tools should be used. To help assess the economic appropriateness of risk-based capital requirements, information should be sought on the nature, degree and sources of the uncertainty surrounding the determination of capital requirements in relation to the established target criteria.

17.9.10 Supervisors should be aware that in some jurisdictions data derived solely from the takāful sector may be of limited reliability for calibration purposes, due to factors such as the small absolute size of the sector or a relatively short history. Supervisors may be able to use data combining takāful and
conventional insurance to provide more data points for calibration purposes. Doing so may also reduce the risk of regulatory arbitrage that might arise if parameters are set differently for the takāful and conventional insurance sectors in the same jurisdiction, without proper supervisory justification. Where combined data are used to calibrate a standardised approach, supervisors should take due care that parameters adopted for takāful take into consideration specificities of takāful that affect the risk distribution.

17.9.11 The degree of measurement error inherent, in particular, in a standardised approach depends on the degree of sophistication and granularity of the methodology used. A more sophisticated standardised approach has the potential to be aligned more closely to the true distribution of risks across TUs. However, increasing the sophistication of the standardised approach is likely to imply higher compliance costs for TOs and more intensive use of supervisory resources (e.g. in validating the calculations). The calibration of the standardised approach therefore needs to balance the trade-off between risk sensitivity and implementation costs.

**Procyclicality**

17.9.12 When applying risk-based regulatory capital requirements, there is a risk that an economic downturn will trigger supervisory interventions that exacerbate the economic crises, thus leading to an adverse "procyclical" effect. For example, a severe downturn in share markets may result in a depletion of the capital resources of a major proportion of TUs. This in turn may force TUs to sell shares and to invest in less risky assets in order to decrease their regulatory capital requirements. A simultaneous massive selling of shares by TUs (and, simultaneously and for similar reasons, conventional insurers) could, however, put further pressure on the share markets, thus leading to a further drop in share prices and to a worsening of the economic crises.

17.9.13 However, the system of solvency control levels required enables supervisors to introduce a more principles-based choice of supervisory interventions in cases where there may be a violation of the PCR control level and this can assist in avoiding exacerbation of procyclicality effects: supervisory intervention is able to be targeted and more flexible in the context of an overall economic downturn so as to avoid measures that may have adverse macroeconomic effects.

17.9.14 It could be contemplated whether further explicit procyclicality-dampening measures would be needed. This may include allowing a longer period for corrective measures or allowance for the calibration of the regulatory capital requirements to reflect procyclicality dampening measures. Overall, when such dampening measures are applied, an appropriate balance needs to be achieved to preserve the risk sensitivity of the regulatory capital requirements.
In considering the impacts of procyclicality, the influence of external factors (e.g. the influence of credit rating agencies) should be given due regard. The impacts of procyclicality also heighten the need for supervisory cooperation and communication.

**Additional Guidance for Insurance Groups and TUs that are Members of Groups**

**17.9.16** Approaches to determining group-wide regulatory capital requirements will depend on the overall approach taken to group-wide capital adequacy assessment. Where a group-level approach is used, either the group’s consolidated accounts may be taken as a basis for calculating group-wide capital requirements or the requirements of each TU or conventional insurance legal entity may be aggregated, or a mixture of these methods may be used. For example, if a different treatment is required for a particular entity (e.g. an entity located in a different jurisdiction), it might be disaggregated from the consolidated accounts and then included in an appropriate way using a deduction and aggregation approach.

**17.9.17** Where consolidated accounts are used, the requirements of the jurisdiction in which the ultimate parent of the group is located would normally be applied. Consideration should also be given to the scope of the consolidated accounts used for accounting purposes, as compared to the consolidated balance sheet used as a basis for group-wide capital adequacy assessment to require, for example, identification and appropriate treatment of non-takāful and non-insurance group entities.

**17.9.18** Where the aggregation method is used (as described in Guidance paragraph 17.2.13), or where a legal entity focus is adopted (as described in Guidance paragraph 17.2.14), consideration should be given as to whether local capital requirements can be used for TUs and conventional insurance legal entities within the group which are located in other jurisdictions or whether capital requirements should be recalculated according to the requirements of the jurisdiction in which the ultimate parent of the group is located.

**Group-Specific Risks**

**17.9.19** There are a number of group-specific factors which should be taken into account in determining group-wide capital requirements, including diversification of risk across group entities, intra-group transactions, risks arising from non-takāful or non-insurance group entities, treatment of group entities located in other jurisdictions, and treatment of partially owned entities and minority interests. Particular concerns may arise from a continuous sequence of internal financing within the group, or closed loops in the financing scheme of the group.

**17.9.20** Group-specific risks posed by each group entity to TUs and conventional insurance members of the group, and to the group as a whole, are a key factor in an overall assessment of group-wide capital adequacy. Such risks are typically difficult to measure and mitigate and include, notably,
contagion risk (financial, reputational, legal), concentration risk, complexity risk and operational/organisational risks. As groups can differ significantly, it may not be possible to address these risks adequately using a standardised approach for capital requirements. It may therefore be necessary to address group-specific risks through the use of more tailored approaches to capital requirements, including the use of (partial or full) internal models. Alternatively, supervisors may vary the standardised regulatory capital requirement so that group-specific risks are adequately provided for in the TU and/or group capital adequacy assessment.38

17.9.21 Group-specific risks should be addressed from both a TU perspective and a group-wide perspective, ensuring that adequate allowance is made. Consideration should be given to the potential for duplication or gaps between TU and group-wide approaches.

Diversification of Risks between Group Entities

17.9.22 In the context of a group-wide solvency assessment, there should also be consideration of dependencies and interrelations of risks across different members in the group. However, it does not follow that where diversification effects exist, these should be recognised automatically in an assessment of group-wide capital adequacy. It may, for example, be appropriate to limit the extent to which group diversification effects are taken into account, for the following reasons:

• Diversification may be difficult to measure at any time and in particular in times of stress. Appropriate aggregation of risks is critical to the proper evaluation of such benefits for solvency purposes.
• There may be constraints on the transfer of diversification benefits across group entities and jurisdictions because of a lack of fungibility of capital or transferability of assets.
• Diversification may be offset by concentration/aggregation effects (if this is not separately addressed in the assessment of group capital).

17.9.23 The benefits of diversification depend upon the extent of correlation between the risks. Supervisors should ensure that where diversification effects are permitted, their quantification takes due consideration of correlation between the risks concerned.

17.9.24 Where segregation of funds is practised by TUs in the group, no diversification benefits should be recognised between segregated funds (or assets in the SHF earmarked as *qard*) and other members of the group, unless the supervisor is satisfied that the funds in question are available to absorb losses elsewhere in the group.

17.9.25 An assessment of group diversification benefits is necessary under whichever approach is used to assess group-wide capital adequacy. Under

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38 See Standard 17.10.
a legal entity approach, recognition of diversification benefits will require consideration of the diversification between the business of a TU and other entities within the group in which it participates and of intra-group transactions. Under an approach with a consolidation focus which uses the consolidated accounts method, some diversification benefits will be recognised automatically at the level of the consolidated group. In this case, supervisors will need to consider whether it is prudent to recognise such benefits or whether an adjustment should be made in respect of potential restrictions on the transferability or sustainability under stress of additional capital resources created by group diversification benefits.

Intra-Group Transactions

17.9.26 Intra-group transactions may result in complex and/or opaque intra-group relationships which give rise to increased risks at both the takāful legal entity and the group level. In a group-wide context, credit for risk mitigation should only be recognised in group capital requirements to the extent that risk is mitigated outside the group. For example, the mitigation of risk by means only of a captive reinsurer or retakāful undertaking should not result in a reduction of overall group capital requirements.

Non-Takāful and Non-Insurance Group Entities

17.9.27 In addition to TUs and conventional insurance legal entities, an insurance group may include a range of different types of non-takāful and non-insurance legal entity, either subject to no financial regulation (non-regulated entities) or regulated under other financial sector regulation. The impact of all such entities should be taken into account in the overall assessment of group-wide solvency, but the extent to which they can be captured in a group-wide capital adequacy measure as such will vary according to the type of non-takāful and non-insurance legal entity, the degree of control/influence on that entity and the approach taken to group-wide supervision.

17.9.28 Risks from non-regulated entities are typically difficult to measure and mitigate. Supervisors may not have direct access to information on such entities, but it is important that supervisors are able to assess the risks they pose in order to apply appropriate mitigation measures. Measures taken to address risks from non-regulated entities do not imply active supervision of such entities.

17.9.29 There are different approaches to addressing risks stemming from non-regulated entities such as capital measures, non-capital measures or a combination thereof.

17.9.30 One approach may be to increase capital requirements in order that the group holds sufficient capital. If the activities of the non-regulated entities have similar risk characteristics to takāful activities, it may be possible to calculate an equivalent capital charge. Another approach might be to deduct the value of holdings in non-regulated entities from the capital
resources of the takāful legal entities in the group, but this on its own may not be sufficient to cover the risks involved.

17.9.31 Non-capital measures may include, for example, limits on exposures and requirements on risk management and governance applied to TUs and conventional insurance legal entities with respect to non-regulated entities within the group.

Cross-Jurisdictional Entities

17.9.32 Group-wide capital adequacy assessments should, to the extent possible, be based on consistent application of TCPs across jurisdictions. In addition, consideration should be given to the capital adequacy and transferability of assets in entities located in different jurisdictions.

Partial Ownership and Minority Interests

17.9.33 An assessment of group-wide capital adequacy should include an appropriate treatment of partially owned or controlled group entities and minority interests. Such treatment should take into account the nature of the relationships of the partially owned entities within the group and the risks and opportunities they bring to the group. The accounting treatment may provide a starting point. Consideration should be given to the availability of any minority interest's share in the net equity in excess of regulatory capital requirements of a partially owned entity.

Variation of Regulatory Capital Requirements

17.10 Any variations to the regulatory capital requirement imposed by the supervisor are made within a transparent framework, are appropriate to the nature, scale and complexity according to the target criteria, and are only expected to be required in limited circumstances.

17.10.1 As has already been noted, a standardised approach, by its very nature, may not be able to fully and appropriately reflect the risk profile of each individual TU. In cases where the standardised approach established for determining regulatory capital requirements is materially inappropriate for the risk profile of the TU (or of one of its constituent funds), the supervisor should have the flexibility to increase the regulatory capital requirement calculated by the standard approach. For example, some TUs using the standard formula may warrant a higher PCR and/or group-wide regulatory capital requirement if they are undertaking higher risks, such as new products where credible experience is not available to establish technical provisions, or if they are undertaking significant risks that are not specifically covered by the regulatory capital requirements.

17.10.2 Similarly, in some circumstances when an approved, more tailored approach is used for regulatory capital purposes, it may be appropriate for the supervisor to have some flexibility to increase the capital requirement calculated using that approach. In particular, where an internal model or
partial internal model is used for regulatory capital purposes, the supervisor may increase the capital requirement where it considers the internal model does not adequately capture certain risks, until the identified weaknesses have been addressed. This may arise, for example, even though the model has been approved where there has been a change in the business of the TU and there has been insufficient time to fully reflect this change in the model and for a new model to be approved by the supervisor.

17.10.3 In addition, supervisory requirements may be designed to allow the supervisor to decrease the regulatory capital requirement for an individual TU (or a fund of a TU) where the standardised requirement materially overestimates the capital required according to the target criteria. However, such an approach may require a more intensive use of supervisory resources due to requests from TOs for consideration of a decrease in their TUs’ regulatory capital requirement. Therefore, the IFSB appreciates that not all jurisdictions may wish to include such an option for their supervisor. Further, this option reinforces the need for such variations in regulatory capital requirements to only be expected to be made in limited circumstances.

17.10.4 Any variations made by the supervisor to the regulatory capital requirement calculated by the TO for the TU should be made in a transparent framework and be appropriate to the nature, scale and complexity in terms of the target criteria. The supervisor may, for example, develop criteria to be applied in determining such variations, and appropriate discussions between the supervisor and the TO may occur. Variations in regulatory capital requirements following supervisory review from those calculated using standardised approaches or approved, more tailored approaches should be expected to be made only in limited circumstances.

17.10.5 In undertaking its ORSA, the TO considers the extent to which the regulatory capital requirements (in particular, any standardised formula) adequately reflect its TU’s particular risk profile. In this regard, the ORSA undertaken by a TO can be a useful source of information to the supervisor in reviewing the adequacy of the regulatory capital requirements of the TU and in assessing the need for variation in those requirements.

Identification of Capital Resources Potentially Available for Solvency Purposes

17.11 The supervisor defines the approach to determining the capital resources eligible to meet regulatory capital requirements and their value, consistent with a total balance sheet approach for solvency assessment and having regard to the quality and suitability of capital elements.

17.11.1 The following outlines a number of approaches a supervisor could use for the determination of capital resources in line with this requirement. The determination of capital resources would generally require the following steps:
• the amount of capital resources potentially available for solvency purposes is identified (see Guidance paragraphs 17.11.3 to 17.11.35);
• an assessment of the quality and suitability of the capital instruments comprising the total amount of capital resources identified is then carried out (see Guidance paragraphs 17.12.1 to 17.12.39); and
• on the basis of this assessment, the final capital resources eligible to meet regulatory capital requirements and their value are determined (see Guidance paragraphs 17.12.40 to 17.12.55).

17.11.2 In addition, the TO is required to carry out its own assessment of its TU's capital resources to meet regulatory capital requirements and any additional capital needs (see Standard 16.14 and IFSB-14).

**Capital Resources under Total Balance Sheet Approach**

17.11.3 The IFSB supports the use of a total balance sheet approach in the assessment of solvency to recognise the interdependence between assets, liabilities, regulatory capital requirements and capital resources so that risks are appropriately recognised (see Figure 17.4).

17.11.4 Such an approach requires that the determination of available and required capital is based on consistent assumptions for the recognition and valuation of assets and liabilities for solvency purposes.

17.11.5 From a regulatory perspective, the purpose of regulatory capital requirements is to require that, in adversity, a TU's obligations to takāful participants will continue to be met as they fall due. This aim will be achieved if technical provisions and other liabilities are expected to remain covered by assets over a defined period, to a specified level of safety.\(^{39}\)

17.11.6 To achieve consistency with this economic approach to setting capital requirements in the context of a total balance sheet approach, capital resources should broadly be regarded as the difference between assets and liabilities on the basis of their recognition and valuation for solvency purposes.

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\(^{39}\) Refer to Guidance paragraphs 17.4.1 to 17.10.5.
17.11.7 When regarding available capital resources as the difference between assets and liabilities, the following issues should be considered:

- the extent to which certain liabilities other than technical provisions may be treated as capital for solvency purposes (Guidance paragraphs 17.11.8 to 17.11.17);
- whether contingent assets could be included (Guidance paragraphs 17.11.18 to 17.11.24);
- the treatment of assets which may not be fully realisable in the normal course of business or under a wind-up scenario (Guidance paragraphs 17.11.25 to 17.11.33); and
- reconciliation of such a “top-down” approach to determining capital resources with a “bottom-up” approach which sums up individual items of capital to derive the overall amount of capital resources (Guidance paragraph 17.11.34).

Treatment of Liabilities

17.11.8 “Liabilities” include technical provisions and other liabilities. Certain items such as other liabilities in the balance sheet may be treated as capital resources for solvency purposes.

17.11.9 For example, perpetual subordinated debt, although usually classified as a liability under the relevant accounting standards, could be classified as a capital resource for solvency purposes.\(^{40}\) This is because of its availability

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\(^{40}\) However, adequate recognition should be given to contractual features of the debt, such as embedded options which may change its loss absorbency.
to act as a buffer to reduce the loss to takāful participants and senior creditors through subordination in the event of insolvency. More generally, subordinated debt instruments (whether perpetual or not) may be treated as capital resources for solvency purposes if they satisfy the criteria established by the supervisor. Other liabilities that are not subordinated would not be considered as part of the capital resources; examples include liabilities such as deferred tax liabilities and pension liabilities.

17.11.10 It may, therefore, be appropriate to exclude some elements of funding from liabilities and so include them in capital to the extent appropriate. This would be appropriate if these elements have characteristics which protect takāful participants by meeting one or both of the objectives set out in Guidance paragraph 17.3.8.

17.11.11 Where segregation of funds is practised, funding may also be provided from one fund (the SHF) to another (typically, a PRF) by way of a loan (qard), with the intended purpose of providing capital or liquidity support. Assets of the SHF are lent to the fund to provide the capital (or liquidity) that the fund requires to commence or sustain its operations, to be repaid only out of future surpluses of the fund. Qard provided for liquidity support represents a liability of the takāful fund and does not normally affect the level of its capital resources. Where, however, the purpose of qard is to provide capital support, then, although the qard still represents a liability of the takāful fund, it is potentially capable of reclassification as capital resources if it has the necessary qualities.

17.11.12 Similar considerations apply to a takāful window to which the host conventional insurer has extended a qard. (Where a window has its own SHF, the foregoing paragraph applies to qard between the window’s SHF and takāful funds.)

17.11.13 The extent to which qard made to a fund (or a window) should count as capital resources in the recipient fund depends, among other things, on the terms on which it is made and the legislation in the jurisdiction relating to such balances in the case where the fund becomes unable to pay all entitlements of its takāful participants. As described in Guidance paragraphs 17.12.8, and 17.12.10 to 17.12.18, subordination is a key characteristic of capital resources, so only where takāful participants’ claims ranked above qard could qard be considered regulatory capital of the highest quality. Subordination to takāful participants’ claims may be achievable by voluntary and irrevocable agreement of the qard provider.

17.11.14 Care should be taken to avoid the possibility of internal leverage through the use of qard. Internal leverage arises where the SHF finances qard paid into a takāful fund (and recognised as capital resources in that fund) with resources that would not have ranked as capital resources of the same or higher quality in the SHF itself.

17.11.15 In order to prevent double counting, creation or enhancement of quality of capital, qard that is recognised as capital resources in a takāful fund should
not be recognised as an asset of the SHF for solvency purposes; or if it is recognised as an asset in the SHF, it should be excluded or deducted from the capital resources of the SHF when assessing the capital adequacy of the SHF (or an equivalent amount added to the SHF’s PCR and MCR). By default, the adjustment for double counting should be performed against the highest quality of capital in the SHF, unless the supervisor is satisfied both that adjustment against a lower quality of capital is justified by the terms of the capital item in question and that it does not result in the qard being recognised at higher quality in the takāful fund. It follows, therefore, that adequate, unencumbered capital of sufficient quality must exist in the SHF before qard is provided, in order for provision of qard to be effective as a form of capital support for a takāful fund.

17.11.16 Supervisors should also consider whether boundaries between the funds of a TU will be respected both when the entity is a going concern and in any form of insolvency proceeding. If this is not the case, supervisors should address these issues with the relevant authorities in their own jurisdictions. This standard does not deal further with the complex issue of insolvency law.

17.11.17 It should be noted that this standard does not identify qard as the sole permissible means of providing additional capital to takāful funds, and the regulatory framework in a jurisdiction may provide for other means, to which the principles set out in this section should be applied by supervisors.

Treatment of Contingent Assets

17.11.18 It may be appropriate to include contingent elements which are not considered as assets under the relevant accounting standards where the likelihood of payment, if needed, is sufficiently high according to criteria specified by the supervisor. Such contingent capital may include, for example, letters of credit, members’ calls by a TO of a mutual TU or the unpaid element of partly paid capital, and may be subject to prior approval by the supervisor.

17.11.19 Where segregation of funds is practised, legislation may allow contingent capital of a takāful fund to include, with supervisory approval, an arrangement (referred to in this standard as a qard facility), being a voluntary and irrevocable commitment by the TO to transfer assets from the SHF to the takāful fund as qard, provided that:

- the supervisor is satisfied that the qard facility can absorb losses in the takāful fund;
- the qard facility is represented by identified assets of the SHF that are earmarked for the qard facility, are otherwise unencumbered and cannot be used to absorb losses of other funds;
- the earmarked assets are:
  - of a nature suitable for solvency purposes of the takāful fund;
  - in a form readily transferable to the takāful fund; and
managed by the TO in accordance with the asset–liability management policy of the takāful fund;\textsuperscript{41}  
- the capital resources represented by the qard facility are not double counted in the capital resources of the SHF; and  
- the TO is legally obliged to transfer the earmarked assets or their proceeds to the takāful fund as qard on the occurrence of prescribed events, including where and to the extent that the takāful fund has insufficient capital resources otherwise to meet its MCR, or the fund or the legal entity is wound up.

17.11.20 As with qard, care should be taken to avoid internal leverage through the mechanism of a qard facility (see Guidance paragraphs 17.11.14 and 17.11.15). In order to avoid double counting the earmarked assets in the SHF for solvency purposes, creating or enhancing the quality of capital, the earmarked assets should be excluded or deducted from the capital resources of the SHF when assessing its capital adequacy (or an equivalent amount added to the SHF’s PCR and MCR). It follows, therefore, that adequate, unencumbered capital of sufficient quality must exist in the SHF before assets are earmarked, in order for a facility of this nature to be effective.

17.11.21 The fund that would bear the cost of a shock to the values of earmarked assets takes the assets into account in computing its fund PCR and fund MCR. Thus, if the SHF is obliged to top up the earmarked assets because their value has fallen, the SHF’s PCR and MCR would reflect this; however, if the takāful fund bore the risk, its PCR and MCR would include the capital charges.

17.11.22 Supervisory approval for the maintenance or extension of a qard facility should be subjected to due supervisory process and should specify the amount of the facility to be recognised as capital resources of the takāful fund or the means of determining that amount. The supervisor should be able to withdraw its approval if it considers it necessary, and to require the TO to transfer the earmarked assets to the takāful fund as waqt, qard or, exceptionally, as a gift (i.e. a hibah arrangement).

17.11.23 For the avoidance of doubt, this TCP does not require jurisdictions to make qard facilities available. Where the regulatory framework in a jurisdiction requires or permits the use of a qard facility mechanism for providing additional capital to PRFs, this TCP does not require maintenance of a qard facility in all circumstances, or specify an amount for such a facility. Rather, it establishes guidance for supervisors as to the approach to be taken where a TO wishes to count shareholders' fund assets towards the solvency of a takāful fund.

\textsuperscript{41} For guidance on investment policy including asset–liability management, supervisors are referred to TCP 15: Investments, TCP 16: Enterprise Risk Management for Solvency Purposes and IFSB-14: Standard on Risk Management for Takāful (Islamic Insurance) Undertakings.
17.11.24 Where takāful windows are permitted, legislation may provide for a similar arrangement whereby access to earmarked assets in the host is recognised as capital resources of the window. In such cases, the supervisor of the window should require the window’s Shari‘ah governance function to include oversight of the assets earmarked, to identify any assets that could not be held by the window, or would require purification if held, to enable these to be excluded from the window’s available capital resources.

Treatment of Assets that May Not be Fully Realisable on a Going Concern or Wind-Up Basis

17.11.25 Supervisors should consider that, for certain assets in the balance sheet, the realisable value under a wind-up scenario may become significantly lower than the economic value which is attributable under going concern conditions. Similarly, even under normal business conditions, some assets may not be realisable at full economic value, or at any value, at the time they are needed. This may render such assets unsuitable for inclusion at their full economic value for the purpose of meeting required capital.42

17.11.26 Examples of such assets include:

• own shares directly held by the TU: the TU has bought and is holding its (or its TO’s) own shares, thereby reducing the amount of capital available to absorb losses under a going concern or in a wind-up scenario;
• intangible assets: their realisable value may be uncertain even during normal business conditions and may have no significant marketable value in run-off or winding-up; goodwill is a common example;
• future income tax credits: such credits may only be realisable if there are future taxable profits, which is improbable in the event of insolvency or winding-up;
• implicit accounting assets: under some accounting models, certain items regarding future income are included, implicitly or explicitly, as asset values. In the event of run-off or winding-up, such future income may be reduced;
• investments in other TUs or financial institutions: such investments may have uncertain realisable value because of contagion risk between entities; also there is the risk of “double gearing” where such investments lead to a recognition of the same amount of available capital resources in several financial entities; and
• company-related assets: certain assets carried in the accounting statements of the TU could lose some of their value in the event of run-off or winding-up – for example, physical assets used by the TO in conducting its business which may reduce in value if there is a

42 In particular, supervisors should consider the value of contingent assets for solvency purposes taking into account the criteria set out in Guidance paragraph 17.12.22.

43 These investments include investment in the equity of, loans granted to, deposits with and bonds issued by the related parties.
need for the forced sale of such assets. Also, certain assets may not be fully accessible to the TU (e.g. surplus in a corporate pension arrangement).

17.11.27 The treatment of such assets for capital adequacy purposes may need to reflect an adjustment to its economic value. Generally, such an adjustment may be effected either:

- directly, by not admitting a portion of the economic value of the asset for solvency purposes (deduction approach); or
- indirectly, through an addition to regulatory capital requirements (capital charge approach).

**Deduction Approach**

17.11.28 Under the deduction approach, the economic value of the asset is reduced for solvency purposes. This results in capital resources being reduced by the same amount. The partial (or full) exclusion of such an asset may occur for a variety of reasons – for example, to reflect an expectation that it would have only limited value in the event of insolvency or winding-up to absorb losses. No further adjustment would normally be needed in the determination of regulatory capital requirements for the risk of holding such assets.

17.11.29 Deduction is also appropriate for assets that should not be included in capital resources as they are to be removed from the TU. Assets or income requiring purification should be excluded from capital resources. Distributions, including distributions of surplus from takāful funds, should be excluded as soon as they are foreseeable.

**Capital Charge Approach**

17.11.30 Under the capital charge approach, an economic value is placed on the asset for the purpose of determining available capital resources. The risk associated with the asset – that is, a potential deterioration of the economic value of the asset due to an adverse event which may occur during the defined solvency time horizon – would then need to be reflected in the determination of regulatory capital requirements. This should take into account the estimation uncertainty inherent in the determination of the economic value.

**Choice and Combination of Approaches**

17.11.31 As outlined above, an application of the deduction approach would lead to a reduction in the amount of available capital resources, whereas an application of the capital charge approach would result in an increase in

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44 This refers to the degree of inaccuracy and imprecision in the determination of the economic value where observable values are not available and estimation methodologies need to be applied. Sources for this estimation uncertainty are, for example, the possibility that the assumptions and parameters used in the valuation are incorrect, or that the valuation methodology itself is deficient.
regulated capital requirements. Provided the two approaches are based on a consistent economic assessment of the risk associated with the relevant assets, they would be expected to produce broadly similar results regarding the overall assessment of the solvency position of the TU.

17.11.32 For some asset classes, it may be difficult to determine a sufficiently reliable economic value or to assess the associated risks. Such difficulties may also arise where there is a high concentration of exposure to a particular asset or type of assets, or to a particular counterparty or group of counterparties.

17.11.33 A supervisor should choose the approach which is best suited to the organisation and sophistication of the takāful sector and the nature of the asset class and asset exposure considered. It may also combine different approaches for different classes of assets. Whatever approach is chosen, it should be transparent and consistently applied. It is also important that any material double counting or omission of risks under the calculations for determining the amounts of required and available regulatory capital is avoided.

Reconciliation of Approaches

17.11.34 The approach to determining available capital resources as broadly the amount of assets over liabilities (with the potential adjustments as discussed above) may be described as a “top-down” approach – that is, starting with the high-level capital as reported in the balance sheet and adjusting it in the context of the relevant solvency control level. An alternative approach that is also applied in practice is to sum up the amounts of particular items of capital which are specified as being acceptable. Such a “bottom-up” approach should be reconcilable to the “top-down” approach on the basis that the allowable capital items under the “bottom-up approach” should ordinarily include all items which contribute to the excess of assets over liabilities in the balance sheet, with the addition or exclusion of items as per the discussion in Guidance paragraphs 17.11.8 to 17.11.33.

Other Considerations

17.11.35 A number of factors may be considered by the supervisor in identifying what may be regarded as capital resources for solvency purposes, including the following:

- the way in which the quality of capital resources is addressed by the supervisor, including whether or not quantitative requirements are applied to the composition of capital resources and/or whether or not a categorisation or continuum-based approach is used;
- the coverage of risks in the determination of technical provisions and regulatory capital requirements;
- the assumptions in the valuation of assets and liabilities (including technical provisions) and the determination of regulatory capital
requirements – for example, going concern basis or wind-up basis, before tax or after tax, etc.;

• takāful participant priority and status under the legal framework relative to other creditors in the jurisdiction;
• overall quality of risk management and governance frameworks in the takāful sector in the jurisdiction;
• the comprehensiveness and transparency of disclosure frameworks in the jurisdiction and the ability for markets to exercise sufficient scrutiny and impose market discipline;
• the development of the capital market in the jurisdiction and its impact on the ability of TOs to raise capital;
• the balance to be struck between protecting takāful participants and the impact on the effective operation of the takāful sector and considerations around unduly onerous levels and costs of regulatory capital requirements; and
• the relationship between risks faced by TUs and those faced by other financial services entities, including conventional insurers and banks.

Additional Guidance for Insurance Groups and TUs that are Members of Groups

17.11.36 The considerations set out in Guidance paragraphs 17.11.3 to 17.11.35 apply equally to TU and group-wide supervision. The practical application of these considerations will differ according to whether a legal entity focus or a group-level focus is taken to group-wide supervision. Whichever approach is taken, key group-wide factors to be addressed in the determination of group-wide capital resources include multiple gearing, intra-group creation of capital and reciprocal financing, leverage of the quality of capital, and fungibility of capital and free transferability of assets across group entities. There may be particular concerns where such factors involve less transparent transactions – for example, because they involve both regulated and non-regulated entities – or where there is a continuous sequence of internal financing within the group, or closed loops in the financing of the group.

Criteria for Assessment of the Quality and Suitability of Capital Resources

17.12 The supervisor establishes criteria for assessing the quality and suitability of capital resources, having regard to their ability to absorb losses on both a going concern and a wind-up basis.

17.12.1 In view of the two objectives of capital resources set out in Guidance paragraph 17.3.8, the following questions need to be considered when establishing criteria to determine the suitability of capital resources for regulatory purposes:

• To what extent can the capital element be used to absorb losses on a going concern basis or in run-off?
• To what extent can the capital element be used to reduce the loss to takāful participants in the event of insolvency or winding-up?
Some capital elements are available to absorb losses in all circumstances – that is, on a going concern basis, in run-off, in winding-up and insolvency – subject to constraints of fund segregation. For example, common shareholders’ funds (ordinary shares and reserves) in the SHF allow a TU to absorb losses on an ongoing basis, are permanently available and rank as the most subordinate instruments in a winding-up, provided that any element forwarded to takāful funds as subordinated qard or earmarked as a qard facility is disregarded in the SHF. Further, this element of capital best allows TUs to conserve resources when they are under stress because it provides a TO with full discretion as to the amount and timing of distributions. Consequently, common shareholders’ funds are a core element of capital resources for the purpose of solvency assessment.

Similarly, at the level of a takāful fund, accumulated surplus allows the fund to absorb its losses on an ongoing basis, is permanently available, and ranks after creditors and policy entitlements in a winding-up (i.e. it is subordinated to them). Consequently, accumulated surplus is a core element of capital resources for the purpose of solvency assessment in a TU. This can be the case whether or not the accumulated surplus is available for application to the benefit of current takāful participants (by distribution or otherwise). Surplus may have been accumulated over time, such that the takāful participants to whom it was attributable are no longer participants in the fund. Such inherited surplus may still be eligible as capital resources of the fund, even if regulation restricts the uses to which it may be put.

The extent of loss absorbency of other capital elements can vary considerably. Hence, a supervisor should take a holistic approach to evaluating the extent of loss absorbency overall and should establish criteria that should be applied to evaluate capital elements in this regard, taking into account empirical evidence that capital elements have absorbed losses in practice, where available.

To complement the structure of regulatory capital requirements, the supervisor may choose to vary the criteria for capital resources suitable for covering the different solvency control levels established by the supervisor. Where such an approach is chosen, the criteria relating to capital resources suitable for covering an individual control level should have regard to the supervisory intervention that may arise if the level is breached and to the objective of takāful participant protection.

For example, considering that the main aim of the MCR is to provide the ultimate safety net for the protection of the interests of takāful participants (even, when fund segregation is practised, in the SHF of a TU), the supervisor may decide to establish more stringent quality criteria for capital resources suitable to cover the MCR (regarding such resources as a “last line of defence” for the TU both during normal times and in wind-up) than for capital resources to cover the PCR.
Alternatively, a common set of regulatory criteria for capital resources could be applied at all solvency control levels, with regulatory capital requirements reflecting the different nature of the various solvency control levels.

In assessing the ability of elements of capital to absorb losses, the following characteristics are usually considered:

- the extent to which, and in what circumstances, the capital element is subordinated to the rights of takāful participants in an insolvency or winding-up (subordination);
- the extent to which the capital element is fully paid and available to absorb losses (availability);
- the period for which the capital element is available (permanence); and
- the extent to which the capital element is free from mandatory payments or encumbrances (absence of encumbrances and mandatory servicing costs).

In the first bullet of Guidance paragraph 17.12.8, this characteristic is inherently linked to the ability of the capital item to absorb losses in the event of insolvency or winding-up. The characteristics of permanence and availability are relevant for loss absorbency under both going concern and winding-up; taken together, they could be described as being able to absorb losses when needed. Under availability, for example, qard made is immediately available, whereas a qard facility requires action to make it available, and is to that extent less available than qard made. The fourth characteristic is related to the degree to which the capital is conserved until needed, and in the case of absence of mandatory serving costs is primarily relevant for ensuring loss absorbency on a going concern basis.

The relationship between these characteristics is illustrated in Figure 17.5.
17.12.11 In the following Guidance (paragraphs 17.12.12 to 17.12.55), we examine how the characteristics of capital resources described above may be used to establish criteria for an assessment of the quality of capital elements for regulatory purposes. It is recognised that views about the specific characteristics that are acceptable may differ from jurisdiction to jurisdiction and will reflect, among other things, the extent to which the pre-conditions for effective supervision exist within the jurisdiction and the risk tolerance of the particular supervisor.

Subordination

17.12.12 To require that a capital element is available to protect takāful participants, it must be legally subordinated to the rights of takāful participants and senior creditors of the TU in an insolvency or winding-up. This means that the holder of a capital instrument is not entitled to repayment, dividends or other returns, however described, once insolvency or winding-up proceedings have been started until all obligations to the takāful participants have been satisfied.

17.12.13 The principle of subordination also implies that the holder of a capital element issued by the SHF of a TU operating a funds segregation model has no recourse to assets either transferred as qard to a takāful fund or earmarked as a qard facility (see Guidance paragraphs 17.11.19 to 17.11.24) until all obligations to the TU's takāful participants have been satisfied.

17.12.14 Subordination of qard (provided to the takāful fund by a TO or other party) to takāful participants’ claims may be achievable by voluntary and
irrevocable agreement of the provider of the qarḍ. If the subordination is for a limited term, the term should be assessed in accordance with Guidance paragraphs 17.12.25 to 17.12.29 (on permanence).

17.12.15 Similar considerations apply in respect of any capital instrument or arrangement issued or arranged by the TO to provide capital support to the SHF or a takāful fund.

17.12.16 In addition, there should be no encumbrances that undermine the subordination or render it ineffective. One example of this would be applying rights of offset where creditors are able to set off amounts they owe the TU against the subordinated capital instrument. Further, the instrument should not be guaranteed by either the TU or another related entity unless it is clear that the guarantee is available subject to the takāful participant priority. In some jurisdictions, subordination to other creditors may also need to be taken into account.

17.12.17 Each jurisdiction is governed by its own laws regarding insolvency and winding-up. Common equity shareholders normally have the lowest priority in any liquidating distribution of assets, immediately following preferred shareholders. In some jurisdictions, TUs can issue subordinated debt that provides protection to takāful participants and creditors in insolvency. While takāful participants are often given a legal priority above other creditors such as sukuk holders, this is not always the case; some jurisdictions treat takāful participants and other creditors equally. Some jurisdictions rank obligations to the government (e.g. taxes) and to employees ahead of takāful participants and other creditors. Where creditors have secured claims, they may rank before takāful participants. The determination of suitable capital elements for solvency purposes is critically dependent upon the legal environment of the relevant jurisdiction.

17.12.18 The supervisor should evaluate each potential capital element in the context that its value and suitability, and hence a TU's solvency position, may change significantly in a wind-up or insolvency scenario. In most jurisdictions, the payment priority in a wind-up situation is clearly stated in law.

**Availability**

17.12.19 In order to satisfy the primary requirement that capital resources are available to absorb unforeseen losses, it is important that capital elements are fully paid.

17.12.20 However, in some circumstances, a capital element may be paid for “in kind” – that is, be issued for non-cash. The supervisor should define the extent to which payment other than cash is acceptable for a capital element to be treated as fully paid without prior approval by the supervisor, and the

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45 Rights of offset will vary according to the legal environment in a jurisdiction.
circumstances where payment for non-cash consideration may be considered as suitable, subject to approval by the supervisor. There may, for example, be issues about the valuation of the non-cash components or the interests of parties other than the TU.

17.12.21 In addition to assets in the SHF earmarked as a *qard* facility (see Guidance paragraph 17.11.19), it may also be appropriate to treat certain other contingent elements of capital as available capital resources in cases where the probability of payment is expected to be sufficiently high (e.g. the unpaid part of partly paid capital, additional contributions, legally enforceable against *takāful* participants, or letters of credit – see Guidance paragraph 17.11.18).

17.12.22 Where a supervisor allows contingent elements of capital to be included in the determination of capital resources, such inclusion would be expected to be subject to meeting specific supervisory requirements or prior supervisory approval. When assessing the appropriateness of inclusion of a contingent element of capital, regard should be had to:

- the ability and willingness of the counterparty concerned to pay the relevant amount;
- the recoverability of the funds, taking into account any conditions which would prevent the item from being successfully paid in or called up; and
- any information on the outcome of past calls that have been made in comparable circumstances by other TUs, which may be used as an indication of future availability.

17.12.23 The availability of capital instruments may also be impaired when capital is not fully fungible within a TU to cover losses arising from the TU’s business. Whereas the fungibility of capital and transferability of assets is primarily an issue in the context of group solvency assessment, it may also be relevant for the supervision of a TU as a legal entity.

17.12.24 This is the case where segregation of funds is practised, such that part of the assets or surplus of the TU is segregated from the rest of its operations in a ring-fenced fund. In such cases, assets in the fund may only be able to be used to meet obligations to *takāful* participants with respect to which the fund has been established. In these circumstances, the TU’s available capital resources relating to the ring-fenced fund can only be used to cover losses stemming from risks associated with the fund (until transferred out of that fund, if that is possible) and cannot be transferred to meet the TU’s other obligations. Similar arrangements can be observed in some jurisdictions for some or all forms of conventional insurance – in particular, life insurance.

*Permanence*

17.12.25 To provide suitable protection for *takāful* participants for solvency purposes, a capital element must be available to protect against losses for a sufficiently long period to ensure that it is available to the TU when
needed. Supervisors may want to determine a minimum period that capital should be outstanding to be regarded as capital resources for solvency purposes.

17.12.26 When assessing the extent of permanence of a capital element, regard should be had to:

- the duration of the TU’s obligations to takāful participants;\(^{46}\)
- contractual features of the capital instrument which have an effect on the period for which the capital is available (e.g. lock-in clauses, step-up options or call options);
- any supervisory powers to restrict the redemption of capital resources; and
- the time it might take to replace the capital element on suitable terms as it approaches maturity.

17.12.27 Similarly, if a capital element has no fixed maturity date, the notice required for repayment should be assessed against the same criteria.

17.12.28 It is important to take into account incentives to redeem a capital element prior to its maturity date which may exist in a capital element and may effectively reduce the period for which the capital is available. For example, a capital instrument that features a rate of return which increases from its initial level at a specified date after issue may give rise to an expectation that the instrument will be paid back at that future specified date.

17.12.29 An incentive to redeem may arise in the case of qarḍ advanced from the SHF or earmarked as a facility, where the TO may be aware that a deficit is possible in the takāful fund and has an incentive to seek repayment or release from the earmark before the deficit is reported. Legislation or the terms of the arrangement should prevent repayment of qarḍ or release from earmarking where it is foreseeable that the takāful fund will fail to meet its PCR.

\textit{Absence of Mandatory Remuneration or Distribution Requirements or Encumbrances}

17.12.30 The extent to which capital elements require shareholder dividend payments or remuneration or distribution and other forms of payment, including principal repayments of qarḍ or repurchase of assets, should be considered, as it will affect the TU’s ability to absorb losses on a going concern basis.

17.12.31 Capital elements that have a fixed maturity date may have remuneration or distribution requirements that cannot be waived or deferred before maturity. The presence of such features also affects the TU’s ability to absorb losses on a going concern basis and may accelerate insolvency if the payment of remuneration or a distribution results in the TU breaching its regulatory capital requirements.

\(^{46}\) The duration of the TU’s obligations to takāful participants should be assessed on an economic basis rather than a strict contractual basis.
17.12.32 Where a capital instrument takes the form of a Shari'ah-compliant fixed-income instrument such as a *sukuk*, the supervisor must consider whether, and to what extent, periodic payments made by the TO on the *sukuk* represent redemption of the principal amount, and the approach to be taken in such cases to preserve the characteristic of permanence.

17.12.33 A further consideration is the extent to which payments to capital providers or redemption of capital elements should be restricted or subject to supervisory approval. For example, the supervisor may have the ability to restrict the payment of dividends or other remuneration or distribution and any redemption of capital resources where considered appropriate to preserve the solvency position of the TU. TOs may also issue capital instruments for which payments and redemptions are fully discretionary or subject to supervisory approval according to the contractual terms.

17.12.34 Some capital instruments or other capital elements of a TU or of a segregated fund are structured so as to restrict the payment of dividends or other return, however described, and any redemption of capital resources where the TU or fund is breaching, or near to breaching, its regulatory capital requirements and/or is incurring loss. The payment of dividends or other return may also be subordinated to *takāful* participant interests in the TU or fund in the case of winding-up or insolvency. In the SHF, payment of dividends or other return may similarly be subordinated to the TO’s contractual and fiduciary obligations to the *takāful* participants. Such features will contribute to the ability of the capital instrument or other capital element to absorb losses of the TU or the fund in question on a wind-up basis provided that any claims to unpaid dividends or other return on the capital instrument or other capital element are similarly subordinated.

17.12.35 In this context, the capital instruments of a *takāful* fund include subordinated *qarḍ* advanced by the SHF and a *qarḍ* facility maintained in the SHF, where these arrangements form part of the capital resources of the fund. Such items are excluded for this purpose from the capital resources of the SHF in order to avoid double counting, as explained in Guidance paragraphs 17.11.15 and 17.11.20. Other capital elements of a *takāful* fund include accumulated surplus, as mentioned at Guidance paragraph 17.12.3, where such accumulated surplus has the characteristics of capital, which include subordination and restriction on distribution as set out in the foregoing paragraph.

17.12.36 It should also be considered whether the capital elements contain encumbrances which may restrict their ability to absorb losses, such as guarantees of payment to the capital provider or other third parties, hypothecation, or any other restrictions or charges which may prevent the TO from using the capital resource when needed. Where the capital element includes guarantees of payment to the capital provider or other third parties, the priority of that guarantee in relation to *takāful* participants'
rights should be assessed. Encumbrances may also undermine other characteristics, such as permanence or availability of capital.

The Use of Shareholders' Fund Support in a Takāful Fund

17.12.37 Where segregation of funds is practised, supervisors should also consider whether, and under what circumstances, qard or a qard facility is suitable as capital support for a takāful fund. If a takāful fund makes persistent surpluses, and those surpluses are not utilised by distribution or other application, it is plausible that the takāful participants’ equity would, over time, become sufficient to meet the fund’s capital adequacy requirements, thus making the qard or qard facility superfluous. However, this may not be plausible in the case of takāful (and, particularly, retakāful) that covers low-frequency and high-severity events, because of the size of the capital requirements for such business. Where a takāful fund is dependent for its capital adequacy on funds either advanced from the SHF or held in the SHF as a qard facility, the supervisor should consider potential impacts on the risk profile of the fund.

17.12.38 Long-term reliance on qard has the potential to cause adverse selection, where takāful is marketed on a basis of surplus distribution, as potential takāful participants may be reluctant to join a fund that carries a substantial debt to be repaid out of surpluses that would otherwise be attributable to the takāful participants. Legislation may therefore provide for the eligibility of qard as capital resources of the fund to be restricted under prescribed circumstances, thus obliging the TO to regularise the situation (whether by writing off the qard, placing the fund into run-off or in some other way), following due Shari'ah governance.

17.12.39 Long-term reliance on a qard facility could also be detrimental to the interests of takāful participants in some circumstances. In a takāful fund with ‘long tail’ claim liabilities, the takāful participants would be bearing (collectively) the cost of the unwinding discount on the claim liabilities. Where the income earned on earmarked assets forming part of the capital resources of the fund is attributed to the SHF, the risk of adverse selection may again be increased in such a situation. Supervisors may therefore consider it necessary to limit the extent to which a fund may rely upon a qard facility before it is required to be ‘drawn’ by transfer to the takāful fund – for example, by including a qard facility in a lower tier of capital whose ability to cover the MCR or PCR of the fund is limited by regulation.

Determination of Capital Resources to Meet Regulatory Capital Requirements

17.12.40 Based on the assessment of the quality of the capital elements comprising the total capital resources potentially available to the TU, the final capital resources suitable to meet the regulatory capital requirements can be determined.

17.12.41 Capital elements that are fully loss absorbent under both a going concern and a wind-up perspective would generally be allowed to cover any of the
different levels of regulatory capital requirements. However, the supervisor may choose to restrict the extent to which the stronger solvency control levels (i.e. control levels which trigger more severe supervisory interventions) may be covered by lower-quality capital resources, or establish minimum levels for the extent to which these stronger requirements should be covered by the highest-quality capital resources. In particular, this consideration applies to amounts of capital resources which are intended to cover the MCR.

17.12.42 To determine the amount of a TU’s capital resources, supervisors may choose a variety of approaches – for example, those which:

- categorise capital resources into different quality classes (“tiers”) and apply certain limits/restrictions with respect to these tiers (tiering approaches);
- rank capital elements on the basis of the identified quality characteristics (continuum-based approaches); or
- do not attempt to categorise or rank capital elements, but apply individual restrictions or charges where necessary.

To accommodate the quality of assets and of capital elements, combinations of the above approaches have been widely used in various jurisdictions for solvency purposes for takāful, conventional insurance and other financial sectors.

**Determination of Capital Resources to Meet Regulatory Capital Requirements – Tiering Approach**

17.12.43 To take into account the quality of capital instruments, a tiering approach is commonly used in many jurisdictions and in other financial sectors. Under a tiering approach, the composition of capital resources is based on the categorisation of elements of capital according to the quality criteria set by the supervisor.

17.12.44 In many jurisdictions, capital elements are categorised into two or three distinct levels of quality when considering criteria for, and limits on, those capital elements for solvency purposes. For example, one broad categorisation may be as follows:

- Highest-quality capital – permanent capital that is fully available to cover losses of the TU at all times on a going concern and a wind-up basis.
- Medium-quality capital – capital that lacks some of the characteristics of highest-quality capital, but which provides a degree of loss absorbency during ongoing operations and is subordinated to the rights (and reasonable expectations) of takāful participants.
- Lowest-quality capital: capital that provides loss absorbency in insolvency/winding-up only.

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47 Capital elements categorised as being of the highest quality are often referred to as “core capital”, and lower levels are often referred to as “supplementary capital”, or similar.
17.12.45 Where segregation of funds is practised, and a tiering approach is adopted, the supervisor should consider whether, in view of the fact that a segregated fund may be unable to issue capital instruments other than a qard facility provided by the SHF, the tiering categorisation of qard or a qard facility should reflect the tier of capital resources in the SHF from which the qard or qard facility is deducted, rather than being determined on a stand-alone basis, in order to avoid enhancement of the quality of capital by inter-fund transaction.

17.12.46 Under a tiering approach, the supervisor would set minimum or upper levels for the extent to which required capital should comprise the various categories or tiers (e.g. high, medium, low) of capital elements. Where established, the level may be expressed as a percentage of required capital (e.g. a minimum level of 50% of required capital for high-quality capital elements, and/or an upper limit for lowest-quality capital might be 25% of required regulatory capital). There may also be limits set on the extent to which required capital may be comprised of certain specific types of capital elements (e.g. perpetual subordinated loan capital and perpetual cumulative preference share capital may be limited to 50% of required capital).

17.12.47 What constitutes an adequate minimum or upper level may depend on the nature of the takāful business and how the requirement interacts with the various solvency control levels. A separation into tiers as set out above assumes that all elements of capital can clearly be identified as belonging to one of the specified tiers and that elements falling into an individual tier will all be of the same quality. In reality, such distinctions between elements of capital may not be clear cut, and different elements of capital will exhibit the above quality characteristics in varying degrees.

17.12.48 There are two potential policy responses to this fact. One is to set minimum quality thresholds on the characteristics the capital must have in order to be included in the relevant tier; as long as these thresholds are met for a given element, then it can be included in the relevant tier of capital without limit. The other approach is to set minimum quality thresholds for limited inclusion in the relevant tier, but to set additional higher-quality thresholds for elements to be permitted to be included in that tier without limit. This approach effectively subdivides the tiers. It permits greater recognition within a given tier for elements of capital which are more likely to fulfil the quality targets specified for that tier.

17.12.49 Where a tiering approach is applied, this should ideally follow the distinction between going concern capital and wind-up capital. Dividing capital into these tiers is an approach that is also used in the context of regulatory capital requirements for the banking sector.

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48 Alternative approaches may also be used in practice – for example, where the levels are expressed as a percentage of available capital.

49 The percentages used may vary for supervisors in different jurisdictions.
**Determination of Capital Resources to Meet Regulatory Capital Requirements – Continuum-Based Approach**

17.12.50 In other jurisdictions, a continuum-based approach may be used in recognising the differential quality of capital elements. Under this approach, elements of capital are not categorised; rather, they are ranked, relative to other elements of capital, on the basis of identified quality characteristics set by the supervisor. The supervisor also defines the minimum acceptable level of quality of capital for solvency purposes and, perhaps, for different solvency control levels. In this way, the capital elements are classified from highest to lowest quality on a continuous basis; only capital elements sitting above this defined minimum level on the continuum would be accepted as capital resources for solvency purposes. Due consideration should again be given to the quality of capital elements to ensure that there is an appropriate balance of going concern and wind-up capital.

**Determination of Capital Resources to Meet Regulatory Capital Requirements – Other Approaches for Determining Capital Resources**

17.12.51 The supervisor may also apply approaches that are not based on an explicit categorisation of capital instruments, but more on an assessment of the quality of individual capital instruments and their specific features. For example, the terms of a hybrid capital instrument may not provide enough certainty that coupon payments will be deferred in times of stress. In such a case, the supervisor’s approach may limit (possibly taking into account further quality criteria) the ability of that instrument to cover the regulatory capital requirements.

**Determination of Capital Resources to Meet Regulatory Capital Requirements – Choice and Combination of Approaches**

17.12.52 Each approach has advantages and disadvantages. Jurisdictions should consider the organisation and sophistication of the takāful sector and choose the best approach appropriate to the circumstances. Whatever approach is used overall, it should be transparent and be consistently applied so that capital resources are of sufficient quality on a going concern and a wind-up basis.

17.12.53 It is recognised that, in some markets, only a limited range of instruments (e.g. pure equity) may meet the quality criteria set out above. Accordingly, supervisors in such markets may wish to restrict the range of instruments that may be included in capital resources for solvency purposes or to apply procedures for prior approval as appropriate. Where segregation of funds is practised, supervisors may similarly restrict the acceptable terms of qarḍ or qarḍ facilities providing intra-fund capital support, or subject them to prior approval.
17.12.54 It is also important that the approach to the determination of capital resources for solvency purposes is consistent with the framework and principles underlying the determination of regulatory capital requirements. This not only includes the implemented range of solvency control levels, but is also relevant with regard to the target criteria underlying the regulatory capital requirements. In particular, the target criteria for regulatory capital requirements, and hence the approach to determining capital resources, should be consistent with the way in which the supervisor addresses the two broad aims of capital from a regulatory perspective as described in Guidance paragraph 17.3.8.

17.12.55 To illustrate this concept, suppose that in setting regulatory capital requirements the supervisor would consider the maximum probability over a specified time period that they would be willing to let unforeseen losses cause the insolvency of a TU or, where segregation of funds is practised, of a constituent fund of a TU. In such a case, TUs would need to maintain, in the appropriate funds where relevant, sufficient capital resources to absorb losses before insolvency or winding-up occurs. Hence, the determination of capital resources would need to lay sufficient emphasis on the first objective stated in Guidance paragraph 17.3.8 (loss absorbency under going concern), and could not entirely rely on the second objective (loss absorbency solely under insolvency or winding-up).

Additional Guidance for Insurance Groups and TUs that are Members of Groups

17.12.56 The considerations set out in Guidance paragraphs 17.12.1 to 17.12.55 apply equally to TU and group-wide supervision. See paragraph 17.11.36 for additional guidance on the criteria for the assessment of the quality and suitability of capital resources for insurance groups and TUs that are members of groups.

Multiple Gearing and Intra-Group Creation of Capital

17.12.57 Double gearing may occur if a TU invests in a capital instrument that counts as regulatory capital of its subsidiary, its parent or another group entity. Multiple gearing may occur if a series of such transactions exists.

17.12.58 Intra-group creation of capital may arise from reciprocal financing between members of a group. Reciprocal financing may occur if a TU holds shares in or makes loans to another entity (a TU or otherwise) which, directly or indirectly, holds a capital instrument that counts as regulatory capital of the first TU.

17.12.59 For group-wide capital adequacy assessment with a group-level focus, a consolidated accounts method would normally eliminate intra-group transactions and, consequently, multiple gearing and other intra-group creation of capital; whereas, without appropriate adjustment, a legal entity focus may not. Whatever approach is used, multiple gearing and other intra-group creation of capital should be identified and treated in a manner
deemed appropriate by the supervisor to largely prevent the duplicative use of capital.

Leverage

17.12.60 Leverage arises where a parent, either a regulated company or an unregulated holding company, issues debt or other instruments which are ineligible as regulatory capital or the eligibility of which is restricted and down-streams the proceeds as regulatory capital to a subsidiary. Depending on the degree of leverage, this may give rise to the risk that undue stress is placed on a regulated entity as a result of the obligation on the parent to pay remuneration or other returns on such instruments. Leverage stress has the potential to affect the takāful funds of TUs indirectly, if the TO seeks to extract or otherwise to use surplus in the takāful fund (e.g. by increasing fees) in order to improve its own ability to meet its parent’s needs. Stress on the TO also potentially limits its willingness or ability to advance qard where necessary.

Fungibility and Transferability

17.12.61 In the context of a group-wide solvency assessment, excess capital in a TU above the level needed to cover its own capital requirements may not always be available to cover losses or capital requirements in other TUs or conventional insurance legal entities in the group. Free transfer of assets and capital may be restricted by either operational or legal limitations. Some examples of such legal restrictions are exchange controls in some jurisdictions, segregation of funds where this is practised, and rights that holders of certain instruments may have over the assets of the legal entity. In normal conditions, excess capital at the top of a group can be down-streamed to cover losses in group entities lower down the chain. However, in times of stress such parental support may not always be forthcoming or permitted.

17.12.62 The group-wide capital adequacy assessment should identify and appropriately address restrictions on the fungibility of capital and transferability of assets within the group in both “normal” and “stress” conditions. A legal entity approach which identifies the location of capital and takes into account legally enforceable intra-group risk and capital transfer instruments may facilitate the accurate identification of, and provision for, restricted availability of funds. Conversely, an approach with a consolidation focus using a consolidated accounts method which starts by assuming that capital and assets are readily fungible/transferable around the group will need to be adjusted to provide for the restricted availability of funds.

General Provisions on the Use of an Internal Model to Determine Regulatory Capital Requirements

17.13 Where a supervisor allows the use of internal models to determine regulatory capital requirements, the supervisor:
• establishes appropriate modelling criteria to be used for the determination of regulatory capital requirements, which require broad consistency among all TUs within the jurisdiction; and
• identifies the different levels of regulatory capital requirements for which the use of internal models is allowed.

17.13.1 Internal models can be considered in the dual contexts of:
• a method by which a TO determines the economic capital needs of its TU; and
• a means to determine a TU’s regulatory capital resources and requirements, where appropriate.

In either case, the quality of the TO’s risk management and governance is vital to the effective use of internal models. If the TO has supervisory approval, internal models can be used to determine the amount of the TU’s regulatory capital requirements. However, a TO should not need supervisory approval, initial or ongoing, for the use of its internal model in determining its TU’s own economic capital needs or management.

17.13.2 One of the main purposes of an internal model is to better integrate the processes of risk and capital management within the TO for the TU. Among other uses, internal models can be used to determine the economic capital needed by the TU and, if a TO has supervisory approval, to determine the amount of the TU’s regulatory capital requirements. As a basic principle, an internal model that is to be used for regulatory capital purposes should already be in established use for determining economic capital. The methodologies and assumptions used for the two purposes should be consistent, any differences being explainable in terms of the difference in purposes.

17.13.3 Where the supervisor allows a range of standardised and more tailored approaches for regulatory capital purposes, including internal models, a TO should have a choice as to which approach it adopts for the TU, subject to satisfying certain conditions established by the supervisor on the use of internal models for regulatory capital purposes.

17.13.4 Where there is a choice of approach allowed by a supervisor, it is inappropriate for a TO to be able to adopt a process of “cherry-picking” between those approaches – for example, by choosing to use its model for regulatory capital purposes only when the model results in a lower capital requirement than a standardised approach. The IFSB supports the use of internal models where appropriate, as they can be a more realistic,

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50 “Economic capital” refers to the capital which results from an economic assessment of the TU’s risks given its risk tolerance and business plans.
51 There are a number of considerations that the TO would also have to make before deciding to invest in constructing an internal model, one of which is cost. The IFSB is not advocating that all TUs must have an internal model (although their use is encouraged where appropriate).
52 Refer to Guidance paragraph 17.13.14 in relation to “cherry-picking” in the particular context of partial internal models.
risk-responsive method of calculating capital requirements, but it discourages any “cherry-picking” practices by TOs.

17.13.5 In particular, where the risk profile of a TU which is using a standardised approach for calculating its regulatory capital requirements is such that the assumptions underlying this approach are inappropriate, the supervisor may use its powers to increase the TU’s capital requirement or to require the TU to reduce the risks it bears. However, in such circumstances, the supervisor should also consider encouraging the TO to develop a full or partial internal model for the TU which might enable its risk profile to be better reflected in its regulatory capital requirements.

17.13.6 Where the supervisor is aware that a TO has an existing internal model but has not sought approval to use it to calculate the regulatory capital requirement for the TU, the supervisor should discuss this decision with the TO.

17.13.7 Effective use of internal models by a TO for regulatory capital purposes should lead to a better alignment of risk and capital management by providing incentives for TOs to adopt better risk management procedures which can:

• produce regulatory capital requirements for TUs that are more risk sensitive and better reflect the supervisor’s target criteria; and
• assist the integration of the internal model fully into the TO’s strategic, operational and governance processes, systems and controls.

Criteria for the Use of an Internal Model to Determine a TU’s Regulatory Capital Requirements

17.13.8 Where a supervisor allows the use of internal models to determine regulatory capital requirements, it should determine modelling criteria, based upon the level of safety it requires, to be used by a TO adopting an internal model for that purpose. These criteria should require broad consistency between all TUs within the jurisdiction, being based on the same broad level of safety requirements applied to the overall design and calibration of the standardised approach to determining regulatory capital requirements. Discussions with the takāful industry in a jurisdiction may also assist in achieving consistency. The supervisor should set out for which of the different levels of regulatory capital requirements the use of internal models is allowed and determine the modelling criteria for each level.

17.13.9 In particular, when considering whether an internal model may be used in determining the MCR, the supervisor should take into account the main objective of the MCR (i.e. to provide the ultimate safety net for the protection of takāful participants) and the ability of the MCR to be defined in a sufficiently objective and appropriate manner to be enforceable. If internal models are allowed for determining the MCR, particular care should be taken so that the strongest supervisory action that may be
necessary if the MCR is breached can be enforced – for example, if the internal model is challenged in a court of law.

17.13.10 The IFSB does not prescribe specific solvency requirements which are compulsory to all IFSB members. Notwithstanding this, the supervisor will need to establish the appropriate modelling criteria to be used by TOs to meet its regulatory capital requirements for TUs, and the TO’s internal models will need to be calibrated accordingly if used for that purpose. The IFSB notes that some supervisors in the conventional insurance sector who allow the use of internal models to determine regulatory capital requirements have set a confidence level for regulatory purposes which is comparable with a minimum investment grade level. Some examples of modelling criteria include a 99.5% VaR$^{53}$ calibrated confidence level over a one-year time frame,$^{54}$ a 99% TVaR$^{55}$ over one year$^{56}$ and a 95% TVaR over the term of the policy obligations. Different criteria apply for PCR and MCR.

17.13.11 If an internal model is used for regulatory capital purposes, the TO should ensure that its regulatory capital requirements determined by the model for the TU are calculated in a way that is consistent with the objectives, principles and criteria used by the supervisor. For example, the TO may be able to apply the confidence level specified in the supervisors’ modelling criteria directly to the probability distribution forecasts used in its internal model. Alternatively, depending on the TO’s own modelling criteria for its economic capital, a TO may have to recalibrate its internal model to the modelling criteria required by the supervisor in order to use it for regulatory capital purposes. This will allow internal models to have a degree of comparability to enable supervisors to make a meaningful assessment of a TU’s capital adequacy, without sacrificing the flexibility needed to make it a useful internal capital model in the operation of the TU’s business. Further elaboration is provided in Guidance paragraphs 17.16.1 and 17.16.2.

17.13.12 It is noted that, due to the TU-specific nature of each internal model, internal models can be very different from each other. Supervisors, in allowing the use of an internal model for regulatory capital purposes, should preserve broad consistency of capital requirements between TUs with broadly similar risks.

**Partial Internal Models**

17.13.13 The IFSB supports the use of partial internal models for regulatory capital purposes, where appropriate. A partial internal model typically involves the

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$^{53}$ VaR is an estimate of the worst expected loss over a certain period of time at a given confidence level.

$^{54}$ This is the level expected in Australia for those insurers that seek approval to use an internal model to determine their MCR. It is also the level used for the calculation of the risk-based solvency capital requirement under the European Solvency II regime.

$^{55}$ TVaR is the VaR plus the average exceedence over the VaR if such exceedence occurs.

$^{56}$ These are the modelling criteria of the Swiss Solvency Test.
use of internal modelling to substitute parts of a standardised approach for the determination of regulatory capital requirements. For example, a TO could decide to categorise its TU’s takāful contracts along business lines for modelling purposes, or to develop an internal model for only one of the funds that it manages, where segregation of funds is practised. If the regulatory capital requirements for some of these categories are determined by modelling techniques, while the capital requirements for other categories are determined using a standardised approach (e.g. applying an internal model to one PRF while using a standardised approach for any other PRF and any PIF, and for the SHF), then this would constitute the TO using a partial internal model to calculate regulatory capital for the TU.

17.13.14 Partial internal models are often used in the conventional insurance sector to smooth transition to full use of an internal model or to deal with instances such as the merger of two insurers, one of which uses an internal model and the other a standardised approach; similar circumstances in the takāful sector could similarly justify the use of a partial internal model. Given the potential complexity of a full internal model, use of a partial internal model could be a satisfactory approach provided its scope is properly defined (and approved by the supervisor). Provided the reduced scope of the internal model is soundly justified, the use of a partial internal model could be allowed as a permanent solution. However, as discussed above, there could be a tendency for a TO to adopt a “cherry-picking” approach in the use of internal models for a TU. This particularly applies where partial modelling is allowed. The supervisor should place the onus on the TO to justify why it has chosen to use only internal models for certain risks or business lines, or certain funds, of the TU. Where this justification is not sound enough, the supervisor should take appropriate action – for example, refuse or withdraw approval of the model or impose a capital add-on until the model has developed to a sufficient degree.

17.13.15 Supervisors should be particularly alert to the risk of inappropriate outcomes arising from the use of internal models for only one or some of the constituent funds of a TU, where there is capital support between the funds (e.g. by way of a qard facility), to ensure that the location of assets within the TU does not result in a materially different PCR overall.

17.13.16 This TCP should be applied to both partial and full internal models. Partial models should therefore be subject, as appropriate, to the full range of tests: the “statistical quality test”, “calibration test” and “use test” (see Guidance paragraphs 17.14.1 to 17.18.8). In particular, a TO should assess how the partial internal model achieves consistency for the TU with the modelling criteria specified by the supervisor for regulatory purposes. As part of the approval process for regulatory capital use, a TO should be required to justify the limited scope of the model and why it considers that using partial internal modelling for determining regulatory capital requirements for the TU is more consistent with the risk profile of the business than the standardised approach, or why it sufficiently matches regulatory capital requirements for the TU. The TO should clearly
document the reasons behind its decision to use partial internal models. If, for example, this is to ease transition towards full internal models, the TO should outline a transitional plan, considering the implications for risk and capital management of the transition. Such plans and use of partial internal models should be reviewed by the supervisor, who may decide to impose certain restrictions on the partial model’s use for calculating regulatory capital (e.g. introducing a capital add-on during the transitional period).

**Additional Guidance for Group-Wide Internal Models**

17.13.17 Where a supervisor allows the use of group-wide internal models to determine regulatory capital requirements, the supervisor should determine modelling criteria for such models, based upon the level of safety required by the supervisor applicable to an insurance group or a TU or conventional insurance legal entity adopting an internal model for that purpose.

17.13.18 The modelling criteria for internal models for regulatory capital purposes and the process for internal model approval that a supervisor establishes should require broad consistency between group-wide regulatory capital requirements and regulatory capital requirements of individual TUs or conventional insurance legal entities.

17.13.19 Group-wide internal models can vary greatly depending on their group-specific nature. In allowing the use of group-wide internal models for regulatory capital purposes, supervisors should preserve broad consistency between insurance groups and TUs or conventional insurance legal entities with broadly similar risks – for example, TUs or conventional insurance legal entities and insurance groups operating through a branch structure in a jurisdiction. The supervisor should design modelling criteria and the process for model approval so as to maintain broad consistency between the regulatory capital requirements determined using internal models and standardised approaches.

17.13.20 The IFSB recognises that modelling criteria may differ among supervisors. For insurance groups operating in multiple jurisdictions, the degree of consistency in regulatory capital requirements across group members may vary.

17.13.21 Each supervisor should set out for which group-wide regulatory capital requirements, corresponding to the solvency control level or levels which

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57 A group-wide internal model is a risk measurement system a group uses for its internal purposes to analyse and quantify risks to the group as a whole, as well as risks to the various parts of the group, to determine the capital resources needed to cover those risks and to allocate capital resources across the group. Group-wide internal models include partial models which capture a subset of the risks to the group and/or all the risks of a subset of the group. Group-wide internal models also include combinations of models in respect of different parts of the group. A TU’s internal model may be part of a broader group-wide model rather than a stand-alone model.
apply to an insurance group, the use of group-wide internal models is allowed.

17.13.22 In particular, when the supervisor considers allowing the use of internal models for the purpose of determining group-wide regulatory capital requirements at the MCR level, the issues relating to possible legal challenges may differ from those encountered in respect of individual insurance legal entities. For example, supervisors may need to work together to establish and coordinate grounds for legal action in respect of the different TUs and conventional insurance legal entities within a group.

Initial Validation and Supervisory Approval of Internal Models

17.14 Where a supervisor allows the use of internal models to determine regulatory capital requirements, the supervisor requires:

- prior supervisory approval for the TO’s use of an internal model for the purpose of calculating regulatory capital requirements for the TU;
- the TO to adopt risk modelling techniques and approaches appropriate to the nature, scale and complexity of the current risks of the TU and those incorporated within its risk strategy and business objectives in constructing its internal model for regulatory capital purposes;
- the TO to validate an internal model to be used for regulatory capital purposes of the TU by subjecting it, at least, to three tests: “statistical quality test”, “calibration test” and “use test”; and
- the TO to demonstrate that the model is appropriate for regulatory capital purposes of the TU and to demonstrate the results of each of the three tests.

Approval of the Use of an Internal Model for Determination of Regulatory Capital Requirements

17.14.1 Where TOs may be permitted to use internal models for calculating regulatory capital requirements of the TU, the models used for that purpose should be subject to prior supervisory approval. The onus should be placed on the TO to validate a model that is to be used for regulatory capital purposes and provide evidence that the model is appropriate for those purposes. The IFSB considers that a TO should not need supervisory approval for the use of internal models in determining its TU’s own economic capital needs.

17.14.2 The supervisor may prescribe requirements which will allow it to assess different models fairly and facilitate comparison between TUs within its jurisdiction. However, overly prescriptive rules on internal model construction may be counterproductive in creating models which are risk-sensitive and useful for TUs. Therefore, although a certain level of comparability can be achieved by the calibration requirements, full and effective comparison across jurisdictions to align best practice may be best achieved by dialogue between supervisors and industry.
17.14.3 The supervisor should require that, in granting approval for the use of an internal model to calculate regulatory capital requirements, it has sufficient confidence that the results being produced by the model provide adequate and appropriate measures of risk and capital. Although the supervisor may encourage TOs to develop internal models that better reflect their risks as soon as possible, this should not lead to models being approved until there is confidence that they are calibrated correctly. The supervisor may therefore feel it necessary to evaluate an internal model over a specified period of time – for example, a few years – prior to approval. For supervisors, approval of an internal model could require considerable expertise (depending on the sophistication of the model) which may need to be developed. In addition, it may be necessary to introduce different supervisory powers to allow the approval of internal models.

17.14.4 The supervisor should use, at least, the “statistical quality test”, “calibration test” and “use test” as the basis of its approval process. While a broad range of internal model approaches may be suitable for internal economic capital assessment purposes, and this should not be subject to supervisory approval, supervisors may want to place requirements on the internal model approaches that would be regarded as acceptable for regulatory capital purposes. In approving the use of an internal model for calculating regulatory capital requirements, the supervisor should consider the primary role of the model as part of the TO’s risk management procedures. Any requirements imposed by the supervisor on the approval of a model for use in determining regulatory capital requirements should not prevent the model from being sufficiently flexible to be a useful strategic decision-making tool which reflects the TU’s unique risk profile. Consistent standards for the approval of a TO’s internal model for a TU should be applied by the supervisor, regardless of whether the model is developed in-house by the TO or by an external party.

17.14.5 The “statistical quality test” and the “use test” are envisaged to be more TU-specific measures which should allow the supervisor to gain an understanding of how a particular TO has embedded its internal model within its TU’s business. The “calibration test” would be used by the supervisor to assess the results from the internal model in comparison to the TU’s regulatory capital requirements and to those of other TUs.

17.14.6 In addition, the TO should review its own internal model and validate it so as to satisfy itself of the appropriateness of the model for use as part of its risk and capital management processes for the TU. As well as internal review, the TO may wish to consider a regular independent, external review of its internal model by appropriate specialists.

Additional Guidance for Group-Wide Internal Models

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58 Validation should be carried out by a different department or personnel to those that created the internal model to facilitate independence.
17.14.7 Each supervisor who permits the use of internal models for regulatory capital purposes at the legal entity and/or group level should require prior supervisory approval for that purpose.

If an insurance group wishes to use its group-wide internal model for regulatory capital purposes in more than one jurisdiction in which it operates, the group may be subject to requirements that differ in a number of ways. Examples of some areas of possible variation may include:

- modelling criteria (risk measure, time horizon, level of safety);
- valuation bases for regulatory capital purposes;
- the risks that have to be modelled;
- treatment of intra-group transactions;
- approach to group-wide capital adequacy (e.g. group level or legal entity focus); and
- recognition of diversification across the group.

A group-wide internal model therefore needs to be sufficiently flexible to meet the differing requirements of each jurisdiction in which it is to be used for regulatory capital purposes.

17.14.8 The involved supervisors of an insurance group that conducts takāful or conventional insurance business in more than one jurisdiction may consider their joint and common interests for the joint approval of the use of a group-wide internal model for regulatory capital purposes. If so, it may improve the efficiency and effectiveness of the approval process if the supervisors agree on common requirements for the process – for example, standardised language or languages for the application process.

17.14.9 Alternatively, the supervisors may independently approve the use of a group-wide internal model. Therefore, an insurance group seeking approval for a group-wide internal model may receive permission from one supervisor to use the model in that jurisdiction, while not receiving approval in another jurisdiction.

17.14.10 Similarly, where a TU operates in other jurisdictions through a branch structure, the supervisors in those branch jurisdictions will have an interest in the solvency of the TU. If local branch supervisors in these jurisdictions are not satisfied with the capital requirements of the home supervisor, possibly because they are determined using internal models, the local branch supervisors may impose limitations on the branch operations. The home supervisor, however, does not need to have the approval of the local branch supervisors in order to approve the use of the TO's internal model for the TU, for its own purposes.

17.14.11 The degree of involvement of different supervisors in the approval process depends on a number of factors as illustrated in Guidance paragraphs 17.14.12 to 17.14.16.

17.14.12 In the simplest case, an insurance group operates in one jurisdiction only. Clearly, only the supervisor in that jurisdiction needs to be involved in the
group-wide internal model approval process. Where there is more than one supervisor in a jurisdiction – for example, where different insurance activities of a group are supervised separately – then both may need to be involved, depending on the scope of the model. Nevertheless, some liaison with supervisors in other jurisdictions may be mutually beneficial to facilitate convergence and comparability across jurisdictions in respect of internal model standards and practice.

17.14.13 In the case of an insurance group that operates in more than one jurisdiction but only applies to use its group-wide internal model for regulatory capital purposes in one jurisdiction – for example, the parent’s jurisdiction – the group does not need group-wide internal model approval of other jurisdictions provided that it is using other approaches to meet the capital requirements of those other jurisdictions. However, the supervisor considering approval of the group-wide internal model may wish to consult the other supervisors about the relevant takāful and conventional insurance markets, the group’s operations in those markets and the standard of modelling.

17.14.14 In the case of an insurance group that wishes to use its group-wide internal model in more than one jurisdiction (e.g. to calculate TU and conventional insurance legal entity PCRs), the supervisor of each of those jurisdictions should consider approval of the specific application of the group-wide internal model in its jurisdiction, having regard to the considerations in Guidance paragraphs 17.14.15 to 17.14.18.

17.14.15 When considering approval of the use of a group-wide internal model for group-wide regulatory capital purposes, each supervisor should consider:
• its group-wide regulatory capital requirements;
• whether, and the extent to which, its jurisdiction allows the use of internal models for regulatory capital purposes (e.g. PCR, or both PCR and MCR);
• how its jurisdiction interacts with the other jurisdictions potentially involved when supervisory intervention is being considered; and
• the arrangements for collaboration between the supervisors of the legal entities within the insurance group.

17.14.16 A supervisor may delegate the approval process to another supervisor or agree to be bound by its decision while retaining supervisory responsibility. Alternatively, a group-wide supervisor may have ultimate decision-making authority over some or all of the supervisors involved. If more than one jurisdiction is concerned, making such authority legally binding may require a treaty between these jurisdictions. To be effective, each arrangement requires a high level of collaboration between supervisors. To require that the model appropriately addresses all categories of risk, the supervisor making the decision needs sufficient knowledge of the local circumstances in which the group operates.

17.14.17 Supervisors should require that the approval process for the use of a group-wide internal model for regulatory capital purposes is sufficiently
flexible to achieve an approach appropriate to the nature, scale and complexity at each organisational level in an insurance group (group/subgroup/individual TU or conventional insurance legal entity). Risks which may have a large impact at the TU or conventional insurance legal entity level may have much smaller significance at the insurance group level. Conversely, risks that may have a small impact at the TU or conventional insurance legal entity level may aggregate to have a larger impact on risk at the group level. The nature and complexity of risks may also vary at different levels in the insurance group.

17.14.18 Whether the group-wide internal model is appropriate for regulatory purposes given the nature, scale and complexity of the risks depends on the regulatory capital requirements of a jurisdiction. While the risk coverage by an internal model may look reasonable from a group-wide perspective, it may not be reasonable from the point of view of each member of the insurance group. For example, in a group of many general TUs or conventional insurers and one small family TU, it may be appropriate from an overall perspective to place less emphasis on the modelling of the family takāful risks. However, this may not be appropriate from the family TU's or supervisor's perspective. In such circumstances, it may be necessary for the group to upgrade its model to include an adequate life takāful risk component or to set up a self-contained internal model for the family TU in order to gain approval.

“Statistical Quality Test” for Internal Models

17.15 Where a supervisor allows the use of internal models to determine regulatory capital requirements, the supervisor requires:
- the TO to conduct a “statistical quality test” which assesses the base quantitative methodology of the internal model, to demonstrate the appropriateness of this methodology, including the choice of model inputs and parameters, and to justify the assumptions underlying the model; and
- that the determination of the regulatory capital requirement using an internal model addresses the overall risk position of the TU and that the underlying data used in the model are accurate and complete.

17.15.1 Given the importance of an embedded internal model to a TO’s risk management policy and operations, an internal model would generally be constructed to deliver a probability distribution of the required risk capital rather than a “point estimate”. A range of approaches could constitute an effective internal model for risk and capital management purposes, and supervisors should encourage the use of a range of different approaches appropriate to the nature, scale and complexity of different TUs and different risk exposures. There are several different techniques to quantify risk which could be used by a TO to construct its internal model. In broad terms, these could range from basic deterministic scenarios to complex stochastic models. Deterministic scenarios would typically involve the use of stress and scenario testing reflecting an event, or a change in conditions, with a set probability to model the effect of certain events (such as a drop in equity prices) on the TU’s capital position, in which the underlying
assumptions would be fixed. In contrast, stochastic modelling often involves simulating very large numbers of scenarios in order to reflect the likely distributions of the capital required by, and the different risk exposures of, the TU.

17.15.2 The IFSB recognises that there are numerous methodologies which a TO could use as part of its stress and scenario testing. For example, a TO may decide to model the effect of various economic scenarios, such as a fall in equity prices or a change in interest rates, on its TU’s assets and liabilities. Alternatively, a TO could consider a run-off approach, where the effect of various scenarios on a specific portfolio of business as it is run off is examined. The TO should use scenarios which it regards as most appropriate for its TU’s business. Where the internal model is used for regulatory capital purposes, the onus is on the TO to demonstrate to the supervisor that the chosen methodology is appropriate to capture the relevant risks for its TU’s business. This includes testing of the model to require that it can replicate its results on request and that its response to variation in input data is adequate, such as that corresponding to changes in base or stress scenarios. Overall capital requirements derived from an internal model can be highly sensitive to assumptions on the effect of diversification across risks. Supervisors and TOs should therefore give particular consideration to aggregation issues. Conducting stress and scenario testing to determine the effect of shocks may be a suitable tool to validate statistical assumptions.

17.15.3 Where an internal model is established to assess risks at a modular level – that is, on a risk-by-risk basis – in order to conduct an overall risk assessment, the TO should aggregate the results for each of these risks for the TU, both within and across business lines. Several methods exist to aggregate the separate results, allowing for diversification effects. The IFSB considers that a TO would generally be expected to decide how best to aggregate and account for the risks to the whole of its business. The determination of overall regulatory capital requirements by the internal model should consider dependencies within, as well as across, risk categories. Where the internal model allows for diversification effects, the TO should be able to justify its allowance for diversification effects and demonstrate that it has considered how dependencies may increase under stressed circumstances.

17.15.4 Internal models need high-quality data in order to produce sufficiently reliable results. The data used for an internal model should be current and sufficiently credible, accurate, complete and appropriate. Hence, a “statistical quality test” should examine the appropriateness of the underlying data used in the construction of the internal model. A “statistical quality test” would include the examination of the aggregation of data, the modelling assumptions and the statistical measures used to construct the internal model. This could include an annual (or more frequent) review of the various items that are being measured (claims, lapses, etc.) updated for the additional data available together with a scrutiny of data from previous periods to determine whether the data continue to be relevant.
Older data may no longer be relevant, possibly due to changes in risks covered, secular trends, or policy conditions and guarantees attaching. Similarly, new data may not be of substantive use when modelling items that require a long-term view of experience (such as testing the predictions of cash flows for catastrophic events).

17.15.5 A TO may not always have sufficient reliable data in-house. In instances where a TO lacks fully credible data, it may rely on industry or other sufficiently credible data sources to supplement its own data. For example, a new company may lack its own historical data and so could use market data sources in constructing its internal model. Some supervisors have published jurisdictional data which may be of some use. It should be noted that data from the conventional insurance sector may be suitable to inform internal model development in takāful, with due allowance for the effect of significant differences between conventional insurance and takāful.

17.15.6 Another possible source of data may be from retakāful providers and conventional reinsurers, whose data pool is typically larger and covers a wider spectrum of the market. It is, however, important to consider that such industry data may not be entirely appropriate for all TUs. Retakāful providers and conventional reinsurers often only receive data in aggregated form and sometimes are only informed of larger claims or from smaller TUs whose market may not be applicable for all or many TUs. Therefore, any data not specific to the TU would need to be carefully considered before deciding it was appropriate for use as the basis for a TU's “statistical quality test”. Even where deemed appropriate, it may still be necessary to adjust the data to allow for differences in features between the data source and the TU.

17.15.7 In assessing suitability of data and of other inputs – for example, assumptions – to the internal model, expert judgment should be applied and supported by proper justification, documentation and validation.

17.15.8 As part of the “statistical quality test”, the TO should be able to demonstrate that the base quantitative methodology used to construct its internal model is sound and sufficiently reliable to support the model's use, both as a strategic and capital management tool, and to calculate the TU's regulatory capital requirements, if appropriate. The methodology should also be consistent with the methods used to calculate technical provisions.

17.15.9 A “statistical quality test” should also include a review of the internal model to determine whether the assets and products as represented in the model truly reflect the TU's actual assets and products. This should include an analysis of whether all reasonably foreseeable and relevant material risks have been incorporated, including any financial guarantees and embedded options. TOs should also consider whether the algorithms used are able to take into account the action of management and the reasonable expectation of takāful participants. Testing should include future projections within the model and, to the extent practicable, “back-testing”
(the process of comparing the predictions from the model with actual experience).

Additional Guidance for Group-Wide Internal Models

17.15.10 For use in determining the regulatory capital requirements of a TU, a group-wide internal model should meet the same standards as applicable to a stand-alone internal model of that TU.

17.15.11 For use for group-wide regulatory capital requirements, group members should be sufficiently engaged with a group-wide internal model and its application to their businesses (through their input to the model, local board involvement, capital allocation, performance measurement, etc.), even if the insurance group does not use the model to determine the regulatory capital requirements of individual group members.

“Calibration Test” for Internal Models

17.16 Where a supervisor allows the use of internal models to determine regulatory capital requirements, the supervisor requires the TO to conduct a “calibration test” to demonstrate that the regulatory capital requirement determined by the internal model satisfies the specified modelling criteria.

17.16.1 As part of a “calibration test”, where an internal model is used for determining regulatory capital, the TO should assess the extent to which the output produced by its internal model is consistent with the modelling criteria defined for regulatory capital purposes, and hence, confirm the validity of using its internal model for that purpose.

17.16.2 The “calibration test” should be used by the TO to demonstrate that the internal model is calibrated appropriately to allow a fair, unbiased estimate of the capital required for the particular level of confidence specified by the supervisor. Where a TO uses different modelling criteria for a TU than those specified by the supervisor for regulatory capital purposes, it may need to recalibrate its model to the supervisor’s modelling criteria to achieve this.

Additional Guidance for Group-Wide Internal Models

17.16.3 See Guidance paragraphs 17.15.10 and 17.15.11 for additional guidance for group-wide internal models.

“Use Test” and Governance for Internal Models

17.17 Where a supervisor allows the use of internal models to determine regulatory capital requirements, the supervisor requires:
- the TO to fully embed the internal model, its methodologies and results, into the TO’s risk strategy and operational processes (the “use test”);
- the TO’s board and senior management to have overall control of and responsibility for the construction and use of the internal model for risk
management purposes, and ensure sufficient understanding of the model’s construction at appropriate levels within the TO’s organisational structure. In particular, the supervisor requires the TO’s board and senior management to understand the consequences of the internal model’s outputs and limitations for risk and capital management decisions; and

- the TO to have adequate governance and internal controls in place with respect to the internal model.

17.17.1 In considering the use of an internal model for regulatory capital purposes by a TO, the supervisor should not merely focus on its use for that narrow purpose, but should consider the wider use of the internal model by the TO for its TU’s own risk and capital management.

17.17.2 The “use test” is the process by which the internal model is assessed in terms of its application within the TO’s risk management and governance processes. In order for the TO’s internal model to be most effective, it should be genuinely relevant for use within its business for risk and capital management purposes.

17.17.3 Where a TO decides to adopt a higher confidence level than the level required for regulatory capital purposes for its own purposes – for example, in order to maintain a certain investment grade rating – then “calibration” testing should also be conducted by the TO to allow it to determine the level of capital needed at this higher level. The TO should then assess whether holding this amount of capital is consistent with the TO’s overall business strategy for the TU.

17.17.4 The TO should have the flexibility to develop its internal model as an important tool in strategic decision making. A TO should therefore have the flexibility to use the most appropriate risk measure and modelling techniques in its internal models. It may be beneficial if the TO is able to demonstrate why it has chosen a particular risk measure, and it should include in its internal model an appropriate recalibration or reconciliation, if necessary, between the modelling criteria used in the model for its own risk and capital management purposes and those set by the supervisor for regulatory capital purposes. Differences between the economic capital and the regulatory capital requirements should be explicit and capable of being explained by the TO to its board and the supervisor.

17.17.5 The “use test” is a key method by which the TO can demonstrate that its internal model is integrated within its risk and capital management and system of governance processes and procedures. As part of the “use test”, a TO should examine how the internal model is used for operational management purposes, how the results are used to influence the risk management strategy and business plan of the TO, and how senior management are involved in applying the internal model in running the business. A TO should demonstrate to the supervisor that an internal model used for regulatory capital purposes remains useful and is applied consistently over time and that it has the full support of and ownership by the board and senior management.
17.17.6 The TO’s senior management should take responsibility for the design and implementation of the internal model, in order to ensure full embedding of the model within the TO’s risk and capital management processes and operational procedures for the TU. The methodology used in building the model should be compatible with the overall enterprise risk management framework agreed to by the board and senior management. Although the board and senior management may not be able to deconstruct the internal model in detail, it is important that the board has overall oversight of the model’s operation on an ongoing basis and the level of understanding necessary to achieve this. The board and senior management should also ensure that processes are in place to update the internal model to take into account changes in the TO’s risk strategy or other business changes.

17.17.7 Various business units within the TO may be involved in the construction and operation of the internal model, such as risk management, capital management, finance and actuarial departments, depending on the size of the TU. The experience and technical ability of staff involved in the construction and operation of the internal model should be an important consideration for the TO. For a model to pass the “use test”, it would be expected that a TO would have a framework for the model’s application across business units. This framework should define lines of responsibility for the production and use of information derived from the model. It should also define the purpose and type of management information available from the model, the decisions to be taken using that information, and the responsibilities for taking those decisions. The “use test” should also ensure the adequacy of systems and controls in place for the maintenance, data feeds and results of the model. The IFSB notes that internal models may require significant IT resources and costs, which should be a consideration for the TO in developing its models.

17.17.8 The IFSB considers that governance processes and communication in respect of an internal model are as important as its construction. An internal model should be subject to appropriate review and challenge so that it is relevant and reliable when used by the TO for the TU. The key elements and results from the internal model should be understood by the key personnel within the TO, including the board, and not only by those who have constructed it. This understanding should ensure that the internal model remains a useful decision-making tool. If the internal model is not widely understood, it will not be achieving its purpose and adding value to the business. The “use test” is key in ensuring the relevance of the internal model to the TU’s business.

Additional Guidance for Group-Wide Internal Models

17.17.9 See Guidance paragraphs 17.15.10 and 17.15.11 for additional guidance for group-wide internal models.

Documentation for Internal Models
Where a supervisor allows the use of internal models to determine regulatory capital requirements, the supervisor requires the TO to document the design, construction and governance of the internal model, including an outline of the rationale and assumptions underlying its methodology. The supervisor requires the documentation to be sufficient to demonstrate compliance with the regulatory validation requirements for internal models, including the “statistical quality test”, “calibration test” and “use test” outlined above.

17.18.1 The TO should document the design and construction of the internal model sufficient for a knowledgeable professional in the field to be able to understand its design and construction. This documentation should include justifications for and details of the underlying methodology, assumptions and quantitative and financial bases, as well as information on the modelling criteria used to assess the level of capital needed.

17.18.2 The TO should also document, on an ongoing basis, the development of the model and any major changes, as well as instances where the model is shown to not perform effectively. Where there is reliance on an external vendor/supplier, the reliance should be documented along with an explanation of the appropriateness of the use of the external vendor/supplier.

17.18.3 The TO should document the results of the “statistical quality test”, “calibration test” and “use test” conducted to enable the supervisor to assess the appropriateness of its internal model for regulatory capital purposes.

Additional Guidance for Group-Wide Internal Models

17.18.4 In view of the potential complexity of a group-wide internal model, the flexibility required and the potential need for multiple supervisory approvals, it is essential that the group fully document all aspects of the group-wide internal model clearly and unambiguously. This documentation process enables supervisors to identify what is approved and what is not approved. Supervisors should require the insurance group to provide thorough documentation of the scope of an internal model, clarifying what falls within and outside of the model boundaries and what parts of the group universe are modelled. Supervisory authorities should know the boundary to the internal model.

17.18.5 The documentation of the group-wide internal model should include at least:

- a full description of the risk profile of the insurance group and how the group models those risks, including the underlying central assumptions and methods;
- the parts, entities and geographical locations of the insurance group and which are included or excluded from the scope of the model submitted for approval;
- specification of which risks are modelled, with particular focus on group-wide risks;
• intra-group transactions such as (subordinated) loans and other hybrid instruments together with their different level of triggers, guarantees, retakāful and conventional reinsurance, capital and risk mitigation instruments, contingent assets and liabilities; off-balance sheet items and special purpose entities;
• the effect of these instruments, either on individual TUs and conventional insurance legal entities or on the insurance group considered as one single economic entity or on both, depending on supervisory requirements and how these effects are modelled;
• justifications for specific decisions taken in terms of assumptions, scope, simplifications;
• the flexibility of the model architecture to cope with central assumptions ceasing to be valid;
• more generally the insurance group’s processes for validating, maintaining and updating the model, including the use of stress testing and scenario analysis and the results of those tests and analyses;
• how the model allows for and models fungibility of capital, transferability of assets and liquidity issues, the assumptions made especially regarding the treatment of intra-group transactions and the free flow of assets and of liabilities across different jurisdictions, and how the group uses the model for an analysis or a qualitative assessment of liquidity issues; and
• the allocation of capital to TUs and conventional insurance legal entities implied by the group-wide model and how this would change in times of stress for insurance groups established in more than one jurisdiction. Such allocation is required by supervisors, even if an insurance group uses a different allocation – for example, by region or business line – for management purposes.

17.18.6 If elements are omitted from the group-wide internal model, the supervisors should require an explanation within the required documentation – for example, if and why a standardised approach is used for some TUs or conventional insurance legal entities, lines of business or risks.

17.18.7 The supervisors should require the insurance group to provide documentation describing whether and how the modelling is consistent over different jurisdictions or conventional insurance or takāful undertakings regarding, for example, modelling criteria, risks, lines of business, intra-group transactions, or capital and risk mitigation instruments, with suitable explanations for any differences in approach.

17.18.8 Diversification/concentration of risks means that some risks or positions are offset or increased by other risks or positions. The supervisors should require, within the framework of the required internal model documentation, a description of how the insurance group:
• incorporates diversification/concentration effects at the relevant different levels within the group-wide internal model;
• measures such effects in normal and in adverse conditions;
• confirms those measurements for reasonableness; and
• allocates diversification effects across the group according to supervisory requirements.

Credit for diversification effects should only be allowed where appropriate, having regard to risk correlations in adverse financial conditions.

Ongoing Validation and Supervisory Approval of the Internal Model

17.19 Where a supervisor allows the use of internal models to determine regulatory capital requirements, the supervisor requires:

- the TO to monitor the performance of its internal model and regularly review and validate the ongoing appropriateness of the model’s specifications. The supervisor requires the TO to demonstrate that the model remains fit for regulatory capital purposes in changing circumstances against the criteria of the “statistical quality test”, the “calibration test” and the “use test”;

- the TO to notify the supervisor of material changes to the internal model made by it for review and continued approval of the use of the model for regulatory capital purposes;

- the TO to properly document internal model changes; and

- the TO to report information necessary for supervisory review and ongoing approval of the internal model on a regular basis, as determined appropriate by the supervisor. The information includes details of how the model is embedded within the TO’s governance and operational processes and risk management strategy, as well as information on the risks assessed by the model and the capital assessment derived from its operation.

17.19.1 Over time a TU’s business may alter considerably, as a result of internal factors or events (such as a change in TO strategy) and external factors or events (such as a change in profit rates), so that the internal model may no longer fully capture the risks to which the TU is exposed unless adapted. The supervisor should reassess a TU’s internal model and the results that it produces on a regular basis against the criteria of the “statistical quality test”, the “calibration test” and the “use test” so that it remains valid for use, both as a strategic decision-making tool in the context of the TO’s own risk and capital management for the TU, and as a means of calculating regulatory capital requirements where appropriate. In general, only material changes to the model (such as changing the underlying model structure or the risk measure used) or to the risks faced by the TU should require the model to be reassessed by the supervisor. A “model change policy” could be agreed between the supervisor and the TO regarding the degree and timing of changes made to the internal model. This would enable the TO to enact minor changes to its internal model without seeking prior supervisory approval (provided the changes are in accordance with the agreed policy), thereby allowing the model to be updated in a quicker and more flexible way.

17.19.2 The TO should be required to notify the supervisor of material changes to the internal model and to properly document changes to enable the
supervisor to assess, for continued approval, the ongoing validity of the model for use in determining regulatory capital requirements. Following any material changes to an internal model, the supervisor may give the TO a reasonable amount of time so that the updated model is embedded in its risk strategies and operational processes.

17.19.3 The TO should demonstrate that the data used in the internal model remain appropriate, complete and accurate for this purpose.

17.19.4 The supervisor should take care that its ongoing validation requirements do not unduly restrict the use of the internal model by the TO for its own risk and capital management purposes for the TU and thereby reduce its ability to comply with the use test.

Additional Guidance for Group-Wide Internal Models

17.19.5 The insurance group should adjust the model for material changes in group composition and operations, including mergers, acquisitions and other structural changes of affiliated entities or jurisdictional changes.

17.19.6 The supervisor should require the insurance group to provide documentation of material changes in group operations and the reasons why continued use of the group-wide internal model would remain appropriate following the change. If such reasons cannot be given or are not sufficient, the supervisor should require the group to propose appropriate model changes as a result of the material change for reassessment of approval by the supervisor.

Supervisory Responsibilities

17.19.7 The IFSB considers that it is essential that supervisors are able to understand fully the TOs' internal models for TUs and be able to appraise their quality. To this end, the supervisor should have access to experienced personnel with appropriate technical ability, as well as sufficient resources. It is likely to take time for supervisors to acquire the necessary experience to appraise a TO's internal model. Without the appropriate experience and resources, the supervisor may be unable to reliably approve the use of a TO's internal model for regulatory purposes. The supervisor may wish to use external specialists that are considered to have the appropriate experience, such as actuarial consultants, accountancy firms and ratings agencies, to assist it in reviewing a TO's internal models. In such instances, the supervisor should retain the final responsibility for review and approval of the use of the internal model for regulatory purposes.

17.19.8 It may be appropriate for a supervisor to consider transitional measures when permitting TOs to use internal models for regulatory capital purposes for the first time. Such measures will permit the necessary time for both TOs and the supervisor to become familiar with the internal models and their uses. For example, during a transition period, the supervisor could include the use of partial internal modelling, to allow the TO to move
gradually to full use of internal models, or the supervisor could require parallel reporting of regulatory capital determined by both the internal model and the standardised approach. The supervisor may also consider applying a minimum capital level during the transition period.

17.19.9 The supervisor may need to impose additional capital requirements (capital add-ons) or take other supervisory action to address any identified weaknesses in an internal model, either prior to approving the use of the model, as a condition on the use of the model, or in the context of a review of the ongoing validity of an internal model for regulatory capital purposes. It may be necessary to introduce additional supervisory powers, to allow such supervisory actions and measures, when internal models are allowed for regulatory capital purposes by a supervisor.

17.19.10 Where a TO which is a subsidiary of an insurance group seeks approval for the use for its TU of an internal model which itself is part of a broader “group model”, the supervisor of this subsidiary should conduct the approval process in close cooperation with the group-wide supervisor. In particular, the supervisor of the subsidiary should check the status of the “group model” and seek information from the group-wide supervisor about its own approval process.

**Supervisory Reporting**

17.19.11 For supervisory approval purposes, supervisors should require the TO to submit sufficient information for them to be able to approve the use of the internal model for regulatory capital purposes and to give confidence to the supervisor that the TO is appropriately carrying out its responsibility to manage its risks and protect the interests of takāful participants. This information should include the results of analysis conducted under the “statistical quality test”, “calibration test” and “use test”. While supervisors should have the power to determine the exact nature and scope of the information they require, supervisory reporting should be appropriate to the nature, scale and complexity of a TU’s business.

17.19.12 The level of information on internal models necessary to allow meaningful assessment by supervisors would be expected to include appropriate information regarding the TO’s risk and capital management strategy for the TU – for example, how the model is embedded into the TO’s governance procedures, overall business strategy, operational procedures and risk processes. A TO should report details of the risks assessed by the model, including how these are identified and measured, as well as information on the results of the internal model analysis, the economic capital derived from these results and how the results of the internal model compare to those derived from the supervisory standardised approach.\(^{59}\)

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\(^{59}\) Supervisors may consider that the comparison between the capital requirements from an internal model and a supervisory standardised approach should only be required during a transition period.
TCP 18: INTERMEDIARIES
The supervisor sets and enforces requirements for the conduct of takāful intermediaries, in order that they conduct business in a professional and transparent manner.

Introductory Guidance

18.0.1 There is a diverse range of organisations and individuals carrying out takāful intermediation, and diverse channels through which this is undertaken. In order to ensure consumer protection and to promote a level playing field among these actors, this TCP applies to the supervision of those conducting the activity of takāful intermediation. Some of the standards under this ICP apply to the supervision of the individuals providing takāful intermediation services to customers. Other standards apply to the organisation within which the takāful intermediation is carried out; where this is the case, it is made clear in the corresponding guidance. Where a TO’s direct sales staff solicit, negotiate or sell takāful as employees of the TO, the supervisor would apply the relevant standards to the TO.

18.0.2 Some intermediaries do not have direct contact with the customer but act with other intermediaries to place business with TUs (such as wholesale intermediaries). Even though they do not necessarily deal directly with the purchaser of takāful, they perform one of the functions in the chain of soliciting, negotiating or selling takāful, and are within the scope of this TCP.

18.0.3 Where the standards under this TCP apply to the intermediary as an organisation, the supervisor should hold those responsible for the intermediary’s governance to account for implementation of the requirements.

18.0.4 Individuals or organisations which only refer (or introduce) potential customers to a TO or takāful intermediary, without carrying out takāful intermediation, are excluded from the scope of this TCP. Also excluded from its scope are persons, such as tax advisers or accountants, who in conducting another professional activity provide:
• advice on takāful cover on an occasional basis in the course of that other activity; or
• information of a general nature on takāful products (without advising on the choice of takāful product provider), provided that the purpose of that professional activity is not to intermediate a takāful contract.

18.0.5 Takāful intermediaries may also perform functions supplemental to takāful intermediation, many of which may be described as outsourced functions of the TO. These supplemental functions may include underwriting, premium collection, administration, management of takāful claims, loss adjusting and claims appraisal. These functions are excluded from the
IFSBB definition of takāful intermediation. However, in some jurisdictions these supplemental functions are included in their definition of takāful intermediation. The outsourcing of processes that are relevant to business conduct is addressed in other TCPs (see TCP 19: Conduct of Business and – for TOs – TCP 9: Risk Management and Internal Controls).

18.0.6 Takāful intermediation involves the interface between TO and customers. Effective assessment of the quality of takāful intermediation to a large extent requires supervisory consideration of policies, processes and procedures that relate to individual relationships with takāful participants and individual transactions.

18.0.7 Where intermediaries are part of a group, the application of appropriate policies and processes on takāful intermediation should be consistent across the group, recognising local requirements and specificities, and should result in the fair treatment of customers on a group-wide basis.

Proportionality with Regard to Intermediaries

18.0.8 Intermediation systems and practices are closely linked with jurisdictions’ tradition, culture, legal regime and the degree of development of takāful markets. For this reason, supervisory approaches to takāful intermediation also tend to vary. Such diversity should be taken into consideration in implementing this TCP in order to promote the fair treatment of customers.

18.0.9 In implementing this TCP, the supervisor should take into account that there are various business models ranging from sole traders to large enterprises, including specialist wholesale or retakāful intermediaries.

18.0.10 The nature of the customers with which an intermediary interacts and the complexity of the products offered are also relevant to the supervisory approach. Retail customers – in particular, vulnerable consumers – have different needs in terms of consumer protection than professional ones; life products with an investment element are typically more complex than general personal lines products.

18.0.11 In light of market diversity, in implementing this TCP, the supervisor should consider focusing on the activity carried out by the intermediary, to ensure consistency and minimise the opportunity for regulatory arbitrage.

18.0.12 Supervisors are faced with balancing the need for consumers to receive an appropriate level of protection and the benefits of innovation and competition. The supervisor should consider whether its licensing and supervisory requirements impose unreasonable barriers to entry for small or emerging intermediary businesses, or inhibit beneficial innovations, and thereby limit the accessibility of takāful coverage to consumers.

Types of Intermediaries
18.0.13 Intermediaries fall into two categories: (i) those acting primarily on behalf of the TO; and (ii) those acting primarily on behalf of the customer.

- Where the intermediary acts primarily on behalf of the TO and sells products for, and on behalf of, one or more TOs, they are often referred to as “agent” or “producer”.
- Intermediaries may act for a single TO (sometimes referred to as “tied”) or several TOs. The products they can offer may be restricted by agency agreements with the TO(s) concerned.
- Where the intermediary acts primarily on behalf of the customer, they are independent of the TO(s) whose products they sell. Often referred to as a “broker” or “independent financial adviser”, they are able to select products from those available across the market.

18.0.14 Some supervisors do not distinguish between different intermediary categories in legislation and instead supervise according to the activity performed. In some jurisdictions, it may be possible for an intermediary to have a different status depending on the customer relationship and the product or service being offered. In others, an intermediary is prevented from acting in any capacity other than the one in which it has been licensed to do business, in order to avoid conflicts of interest.

18.0.15 Intermediary operations range from large international organisations to local sole traders. Intermediary organisations sometimes operate as independent enterprises or divisions of TOs or other financial institutions, or as part of non-financial organisations. Takāful intermediation may also be performed by digital means, such as website and mobile phone applications.

18.0.16 TOs use various distribution channels to market and sell takāful products. These can include a variety of partners – such as car dealerships, post offices, mobile phone operators, travel agents, other financial institutions and other retailers – who offer takāful alongside or as an add-on to the primary goods and services in which they trade. In many cases, the activities of these distribution channels would constitute intermediation.

**Intermediaries’ Role in Promoting Public Trust and Confidence in the Takāful Sector**

18.0.17 In most takāful markets, intermediaries serve as important distribution channels of takāful. Their good conduct and professional competence are essential to promote confidence in takāful markets.

18.0.18 It is in the interests of supervisors, in promoting fair, safe and stable takāful markets, that the public has trust and confidence in the takāful sector. Takāful intermediaries’ interface between consumers and TOs gives them a key role in building and justifying this public trust and confidence.

18.0.19 In some jurisdictions, intermediaries’ duty to act in a professional and transparent manner is supported by professional bodies and other interested organisations. Such organisations encourage, among other things, the obtaining of professional qualifications, continuous professional
development, ethical behaviour, the fair treatment of customers and better communication with the public. Such measures are aimed at enhancing public confidence in takāful intermediaries through raising professional standards.

**Intermediaries’ Role in Promoting Financial Awareness**

18.0.20 Intermediaries can promote consumer protection by assisting consumers to make better-informed decisions about the products they buy. This helps to address a core consumer protection concern about asymmetries of information between financial services product providers and the public to whom the products are sold. The adoption of good conduct-of-business practices by TOs and takāful intermediaries helps to ensure that customers are sufficiently informed on the takāful products they are considering buying, before concluding a contract.

18.0.21 Enhancing financial awareness is a further means of ensuring that consumers are aware of the types of products available to them and understand their purpose, how they work and their key features, including cost. This understanding helps consumers to compare products and to purchase takāful products that meet their needs. Enhanced financial awareness can be achieved, for example, through formal education initiatives and targeted awareness campaigns led by TOs and intermediaries, individually or jointly.

18.0.22 The promotion of financial awareness may benefit consumers in jurisdictions where consumer protection standards are weak or levels of financial literacy are low. It is also especially important when dealing with more complex financial products, particularly those with an investment element.

18.0.23 Improved understanding by consumers of the terms and benefits they can expect from takāful products may also lead to a reduction in complaints against intermediaries or the TOs whose products they sell.

18.0.24 Takāful intermediaries are not the only stakeholders in promoting the financial awareness of consumers; governments, supervisors, social interest organisations and TOs have a significant role to play in consumer protection. Other stakeholders, using various communication channels, are also able to play a significant role. Nevertheless, intermediaries’ face-to-face dealings with their customers and marketing of products to consumers place them in a position to contribute to strengthening the financial awareness of the public on takāful matters. Supervisors may therefore wish to encourage takāful intermediaries to promote financial awareness.

18.0.25 A variety of means may be used by takāful intermediaries to promote financial awareness, such as:
• explaining face-to-face the features of products in which customers may be interested, which may be particularly important where their interest is in complex or long-term contracts;
• providing references to specific websites or other reference material which gives relevant information, or publishing such material themselves;
• making available, or suggesting other sources of, financial tools such as online calculators which estimate premiums or coverage levels; or
• participating in educational initiatives such as training seminars.

18.0.26 In undertaking financial education initiatives, intermediaries should ensure that the personnel involved have sufficient knowledge for this purpose and that material or tools provided are up to date, free from error to the extent practicable, and easily understood. Such initiatives may target specific audiences, such as vulnerable groups.

18.0.27 Intermediaries’ initiatives to promote financial awareness, where conducted with professionalism, may help to enhance both their own reputation and that of the takāful sector.

Intermediation of Takāful Business

18.0.28 It is likely that in many jurisdictions those intermediating takāful business will also be intermediating other forms of financial service. Intermediaries may specialise only in Islamic finance, but others may offer both Islamic and conventional financial products. Intermediaries may play a role in the extension of takāful coverage by bringing the existence and nature of takāful to the attention of those seeking cover and advising on its characteristics.

18.0.29 Advice on the nature of takāful products requires the intermediary to have adequate knowledge of the features of any given product and of the operator making it available. Intermediaries need to be able to provide information to customers that is relevant to the customer’s decision whether or not to participate in a product. For takāful, that information may include matters that would not arise for conventional insurance (e.g. the purity of the operation and its income, the operating model and contract type adopted, the financial soundness of the segregated fund into which business is to be placed, and the provisions, if any, for distribution of surplus).

Additional TCPs Applicable to the Supervision of Intermediaries

18.0.30 TCP 19: Conduct of Business addresses conduct-of-business supervision in respect of both intermediaries and TOs, whereas this TCP addresses other aspects of supervision that are specific to intermediaries. Other TCPs that apply, generally or in part, to the supervision of intermediaries are:
• TCP 21: Countering Fraud in Takāful; and

18.0.31 Where an intermediary purports to provide intermediation services on a Shari‘ah-compliant basis, TCP 8: Shari‘ah Governance also applies to the intermediary, in a manner proportionate to the nature and scale of its activities. For example, an intermediary representing to customers and to TOs that its operations are Shari‘ah-compliant should have and maintain a basis for such representations. While the formality of a Shari‘ah board may be impractical for many intermediaries, an intermediary should be able to demonstrate to the supervisor that representations as to Shari‘ah compliance are founded on a reasoned basis and that appropriate Shari‘ah governance is in place.

Supervisory Cooperation

18.0.32 In some jurisdictions, the supervision of takāful intermediaries is the responsibility of a different authority than the takāful conduct-of-business supervisory authority. Even where the same authority is responsible for conduct of business and intermediary supervision, the supervisory responsibilities are often undertaken within different departments. Where different authorities or departments are involved, the takāful intermediary supervisor should communicate, and cooperate where possible, with other relevant authorities and departments to ensure an understanding of all the risks relevant to their supervision of takāful intermediaries.

18.1 The supervisor requires takāful intermediaries operating in its jurisdiction to be licensed.

18.1.1 In some jurisdictions, other terminology such as “authorisation” or “registration” are used in place of “licensing”. For the purposes of this TCP, these terms are collectively referred to as “licensing”.

18.1.2 The supervisor may choose to license intermediaries at the legal entity level or the individual level, or both. In some jurisdictions, takāful intermediation activities carried out by the TO’s direct sales staff or its authorised representatives are covered by the TO’s licence; in others, these may require separate intermediary licensing.

18.1.3 Where licensing is at the legal entity level, the supervisor may consider whether the legal entity has in place procedures to ensure that the individuals who conduct takāful intermediation under its responsibility meet appropriate standards of professionalism and competence. The supervisor may also wish to set its own requirements for approval of individuals, within a takāful intermediary, who conduct intermediary business.

18.1.4 For example, the supervisor may limit an intermediary’s power to distribute takāful products, or takāful products of a particular type, if the supervisor is not satisfied that the intermediary has sufficient knowledge of takāful products to advise consumers on their use.
18.1.5 The licensing process should be designed to enable the supervisor to reject a licence application where it considers that the applicant will be incapable of delivering fair consumer outcomes or where it cannot be effectively supervised. For these purposes the supervisor may require an application, together with additional information that may depend on the type of licence being applied for, and may include items such as:

- details of ownership, including all information necessary to provide a full understanding of the takāful intermediary’s ownership and control structure;
- a business plan, including details of proposed business and financial projections;
- the proposed sources and method of capitalisation;
- information on personnel, in particular on proposed holders of key functions;
- details of any significant third-party service providers;
- details of the proposed auditor, where applicable;
- details of professional indemnity takāful or conventional insurance cover, including amount and limitations, or comparable guarantee, where applicable;
- business continuity plans;
- if incorporated, relevant information on incorporation such as memorandum and articles of association and certificate of incorporation;
- details of policies, procedures and controls in key areas such as:
  - new business;
  - client money;
  - complaints;
  - conflicts of interest;
  - compliance;
  - combating financial crime (including AML/CFT and fraud); and
  - a copy of the policy and supporting documents that govern the takāful intermediary’s conduct of business, or confirmation of agreement to conduct-of-business rules published by the supervisor.

The supervisor may require additional information to complete the licensing process, upon request.

18.1.6 The supervisor may set minimum financial resource requirements – for example, to discourage market entrants with insufficient financial resources and to help ensure that existing licensees have sufficient financial resources for business continuity purposes. Where this is the case, such requirements may take into account factors such as the nature of the business to be intermediated, whether the intermediary operates client accounts, the level of any professional indemnity takāful and the level of operating expenses, to ensure that an appropriately risk-based financial resource requirement is set.
18.1.7 The supervisor requires, as a condition of a licence, that an intermediary proposing to distribute takāful products has and maintains adequate knowledge of takāful products that it proposes to distribute.

18.1.8 The supervisor should only issue a licence if the applicant meets the initial licensing conditions.

18.1.9 In specific and limited circumstances, the supervisor may have the power to make exceptions to certain licensing requirements. The supervisor should ensure that any such exceptions do not encourage regulatory arbitrage or increase the risk to consumers.

18.1.10 The supervisor should consider what licensing requirements are applicable to intermediaries operating on a cross-border basis from outside the jurisdiction. These requirements should be transparent to consumers, as well as to intermediaries, so that they can make an informed decision when choosing to deal with intermediaries from other jurisdictions.

18.1.11 The supervisor may consider the possibility of issuing periodically renewable licences. An advantage of doing so would be to ensure formal periodic reassessment of compliance with the regulatory licensing requirements.

18.2 The supervisor ensures that takāful intermediaries licensed in its jurisdiction are subject to ongoing supervisory review.

18.2.1 The supervisor should require that initial licensing conditions, as applicable, are maintained subsequent to the licence being issued and that ongoing regulatory requirements are met. Where another authority is responsible for setting the licensing requirements, the supervisor should communicate, and cooperate where possible, with this authority.

18.2.2 The supervisor may choose to take a risk-based approach in reviewing on a targeted basis whether takāful intermediaries fulfil their licensing and conduct-of-business requirements on an ongoing basis. Under such an approach, supervisory review should take into account the differing size of intermediaries, their likely impact on the market, and the riskiness and complexity of their business.

18.2.3 In addition to monitoring ongoing compliance, the supervisor should require that any breaches in licensing conditions or other supervisory requirements are reported promptly.

Direct Supervision

18.2.4 Direct ongoing supervision may take various forms, both off-site monitoring and on-site inspection, as necessary, as well as other supervisory tools. Further information on this topic is available in TCP 10: Supervisory Review and Reporting, but may require adaptation to make it appropriate for the specific nature of intermediary business. The balance
between off-site and on-site approaches will typically be influenced by the number and nature of intermediaries in the market, as well as by the supervisor’s resources. The supervisor may take these factors into account when determining the balance between a proactive and reactive approach to ongoing supervision.

18.2.5 Off-site monitoring may include supervisory reporting, analysis of complaints, thematic reviews and other forms of information. The supervisor may specify information to be provided for off-site monitoring purposes, including information to be reported routinely or on an ad hoc basis. Supervisory reporting requirements may include:

- financial statements, audited where applicable, or other certification of the financial soundness of the intermediary;
- auditor’s management letter, where applicable;
- confirmation of professional indemnity cover (including exclusions or limitations) or comparable guarantee;
- information on the sources of and placement of business;
- summary of movements on client money accounts, where applicable;
- changes in key functions and significant owners;
- financial links with TOs and other intermediaries (such as through related party structures or service contracts);
- types of products sold;
- business partners;
- staff compensation policy;
- incentive arrangements;
- claims data;
- complaints data; and
- details of advertising and marketing expenditure relating to particular types of products or distribution channels.

18.2.6 Where the intermediary is an employee of the TO, the supervisor may determine that information provided by the TO as part of the TO’s regular reporting responsibilities is sufficient, without requiring separate reporting in respect of the intermediation activities conducted by the employee of the TO.

18.2.7 The supervisor may also use regular formal meetings with intermediaries as a means of supplementing these off-site and on-site processes and procedures. Where appropriate, the supervisor may use other tools, such as “mystery shopping”, to evaluate whether the implementation of intermediaries’ internal policies and processes is resulting in fair outcomes for customers.

18.2.8 Where applicable, the supervisor should apply supervisory review processes and procedures to takaful intermediaries at the level at which licensing takes place (entity or individual level) or at the TU level. Reporting requirements in respect of a TO’s direct sales staff would be the responsibility of the TO.

18.2.9 On-site inspections may consider areas such as:
• corporate governance framework, including internal controls;
• procedures and controls for combating financial crime;
• review of client money accounts where applicable;
• review of customer files;
• review of complaints;
• review of disclosure to customers and terms of business agreements;
• review of documentation of advice given and the reasons for that advice; and
• other relevant elements such as the strategy, business activities and business models, the treatment of customers, and compliance with supervisory requirements.

18.2.10 Where an intermediary represents to customers or to TOs that its operations are Sharī‘ah-compliant, supervisory on-site inspection may include consideration of the governance applied by the intermediary to ensure that the representation is justified on an ongoing basis.

18.2.11 Analysis of complaints may be a valuable source of information for the supervisor, as well as for TOs and intermediaries, in identifying possible risks of poor conduct in the area of takāful intermediation.

18.2.12 The supervisor may take a risk-based approach, where greater attention is focused on higher-risk areas. Examples include where:
• takāful intermediation includes the provision of advice;
• the nature of the business intermediated is more complex;
• customers are less sophisticated; and
• there is an increased likelihood of conflicts of interest.

Indirect Supervision

18.2.13 In some jurisdictions, intermediaries are supervised indirectly through the supervision of the TUs. The supervisor will need to take into account the extent to which such an approach achieves effective supervision. Regardless of the approach, it is ultimately the supervisor’s responsibility that intermediaries are effectively supervised.

18.2.14 An indirect approach may be more appropriate for agency intermediation rather than the broker model.

18.2.15 Indirect supervision can relate to circumstances where the TO relies upon an intermediary to perform processes on its behalf. In such cases, written agreements could be checked by the supervisor to assess the respective responsibilities. For example, TOs are expected to obtain appropriate documentation regarding their customers to demonstrate that appropriate customer due diligence and/or fact-finding procedures have been carried out. TOs will be assessed on the adequacy of the processes carried out and documentation obtained, including where the TO relies upon intermediaries to perform this work and supply the documentation required.
Where the supervision of intermediaries is undertaken indirectly, the supervisor should assess the TO’s processes to monitor the work undertaken by an intermediary on its behalf.

**Self-Regulatory Organisations**

A self-regulatory organisation (SRO) can be described as a non-government organisation that has the power to create and enforce industry or professional regulations and standards. The self-regulatory functions of an SRO can contribute to the supervision of intermediaries through the requirements for, and enforcement of, professional standards for its members.

In jurisdictions with an SRO for intermediaries, the supervisor should assess whether the SRO meets appropriate standards before placing any reliance on the SRO’s self-regulatory functions. The supervisor’s assessment should consider matters such as whether the SRO:

- has sufficient independence;
- has appropriate powers and resources to fulfil its mission and provide effective self-regulation;
- performs its self-regulatory functions adequately;
- establishes and maintains standards that are sufficiently robust; and
- takes appropriate action to deal with any shortcomings.

An SRO's regulations and standards may not address all the aspects of the supervision of takāful intermediaries for which the supervisor has responsibility. Therefore, while the supervisor may choose to place some reliance on the self-regulatory functions of an SRO, the supervisor should retain overall responsibility for supervision.

**Other**

In addition to direct and indirect supervision of intermediaries, the supervisor may use the supervision of TOs to gather information on and, to some extent, monitor intermediaries’ activities. This may include, for example, identifying whether particular intermediaries or particular matters are the subject of regular or frequent complaints.

The supervisor requires takāful intermediaries to maintain appropriate levels of professional knowledge and experience, integrity and competence.

**Professional Knowledge and Experience**

It is important that individuals carrying out the activity of takāful intermediation have adequate professional knowledge. Professional knowledge can be gained from experience, education and/or training. The attainment of relevant professional qualifications may demonstrate that a certain level of professional knowledge has been achieved.
18.3.2 The supervisor should require that individuals carrying out the activity of \textit{takāful} intermediation have professional knowledge and experience appropriate for the business which they intermediate. More complex products or customer needs may require higher or more specialised knowledge and experience. The knowledge and experience of individuals should also be appropriate for the type of business being intermediated. Once professional qualifications have been achieved, it is important that individuals who continue to carry out the activity of \textit{takāful} intermediation keep their professional knowledge up to date. In some jurisdictions, there are supervisory or statutory requirements that individuals carrying out the activity of \textit{takāful} intermediation should spend a specified minimum amount of time on continuous professional development. In some jurisdictions, professional bodies impose such a requirement on their members.

18.3.3 The supervisor may consider recognising the qualifications of specified professional bodies. Where a jurisdiction has no such professional body, consideration could be given to encouraging or recognising qualifications obtained through professional bodies in other jurisdictions. The supervisor may also consider recognising such qualifications where these are considered to be equivalent to, or exceed, the qualifications available within the jurisdiction.

18.3.4 Intermediaries should be knowledgeable regarding the status of the TOs whose \textit{takāful} products they sell. For example, they should be satisfied that the TO is licensed to sell \textit{takāful} in the relevant jurisdiction, as a branch or subsidiary, and should be aware of the financial status and credit rating of the TU and the applicability of any PPSs to that TU's products.

\textbf{Integrity}

18.3.5 It is essential that those carrying out the activity of \textit{takāful} intermediation act with integrity and high ethical standards. These relate to the behaviour of the individuals concerned, such as:
\begin{itemize}
  \item being honest, trustworthy and open;
  \item being reliable, dependable and respectful;
  \item not taking unfair advantage; and
  \item not accepting or offering gifts where this might imply an improper obligation.
\end{itemize}

18.3.6 The supervisor may require individuals carrying out the activity of \textit{takāful} intermediation to be subject either to their organisation's internal policies and processes, or to the ethical standards of professional bodies, that require integrity.

18.3.7 The supervisor may establish its own expectations of integrity through, for example, the publication of codes of conduct with which such individuals are required to comply. Codes of conduct should be complementary to the relevant legislation and may address any aspect of dealings between \textit{takāful} intermediaries and their customers.
18.3.8 Intermediary organisations should have procedures to assess the integrity of those intermediating on their behalf. Such procedures should include pre-employment checks as well as ongoing requirements. Pre-employment checks should include, among other things, employment history, any civil liability, criminal convictions, administrative actions by regulatory agencies and SROs, or pending legal proceedings.

**Competence**

18.3.9 The supervisor should require individuals carrying out the activity of takāful intermediation to act only in respect of business for which they have the required competence.

18.3.10 The supervisor should require takāful intermediaries to implement policies and processes to assess the competence of individuals carrying out the activity of takāful intermediation. Assessment would be particularly important in the case of new employees or where staff are assigned different or more challenging responsibilities. Competence should also be monitored as an ongoing process for all relevant staff. This may include actions such as:

- observed interviews with customers;
- review of customer files;
- internal interviews; and/or
- coaching.

18.3.11 An on-site inspection may provide an opportunity for the supervisor to assess competence, such as through file reviews and interviews of selected staff.

**Role of Professional Standards**

18.3.12 SROs and other professional bodies can be instrumental in promoting professional standards where they issue standards or codes with which their members are required to comply. Standards required by relevant SROs or other professional bodies may include areas such as:

- acting with high ethical standards and integrity;
- acting in the best interests of each client;
- providing a high standard of service; and
- treating customers fairly.

18.3.13 Members of an SRO or other professional body who are found to be in breach of its professional standards may be subject to disciplinary procedures such as suspension of, or exclusion from, membership.

18.3.14 In jurisdictions where there is reliance on the membership of a professional body, the supervisor may consider confirming that such a body has an effective disciplinary scheme in force. The supervisor may nevertheless decide not to depend on such professional processes entirely and deal with issues of an individual’s professional conduct directly.
18.4 The supervisor requires that *takāful* intermediaries apply appropriate governance.

18.4.1 A *takāful* intermediary’s governance framework may vary, depending upon the nature and scale of the intermediary and the complexity of its business, and may be subject to general company law. However, each intermediary’s governance framework should be sufficient to provide for sound and prudent management of the business and to support the fair treatment of customers.

18.4.2 In setting relevant governance requirements the supervisor should consider the application of such requirements to sole traders and small businesses operating as *takāful* intermediaries. Such requirements for sole traders and small businesses will differ from those for larger entities. Key areas where requirements may vary include internal controls, segregation of duties, and compliance functions. Regardless, the supervisor should be satisfied that a sound level of governance is achieved and that there are no unacceptable risks, with the overriding objective that customers are appropriately protected.

18.4.3 Good governance may be promoted by the supervisor, as well as other authorities, professional bodies and SROs, by publishing guidance (e.g. a Code of Practice) for *takāful* intermediaries on their obligations in respect of governance-related matters. Guidance that may help intermediaries meet governance requirements may include matters such as:

- ensuring that those responsible for the intermediary organisation’s governance have the competence and integrity to fulfil their respective roles;
- ensuring appropriate standards for conduct of business;
- ensuring there is regular monitoring of consumer outcomes;
- ensuring that the making of key decisions is subject to sufficient discussion at board level or with key persons in control functions as appropriate;
- ensuring adequate human resources to conduct the business;
- ensuring an appropriate level of internal controls of the business;
- ensuring that appropriate disciplinary policies and processes for wrongdoing are in place;
- maintaining adequate files and records and ensuring their availability for inspection;
- maintaining appropriate controls over outsourced functions; and
- compliance with all relevant legislation, including non-*takāful* legislation such as in respect of anti-money laundering, fraud, etc.

18.4.4 Guidance addresses the obligations of intermediaries engaged in the distribution of *takāful* products, ensuring that such intermediaries maintain knowledge of the products they intermediate, and that they act in good faith and on reasonable grounds to provide the customer with the product indicated by the customer’s needs, or the client’s requests, without regard to the interests of the intermediary.
18.4.5 Relevant to governance, intermediaries are required to establish and implement policies and processes on the fair treatment of customers that are an integral part of their business culture (see Standard 19.3).

18.4.6 The governance of a TO’s direct sales staff is the responsibility of the TO, and the governance of TUs is the subject of TCP 7: Corporate Governance. Although TCP 7 is otherwise not directly applicable to intermediaries, it may be a useful source of information for intermediary supervisors.

18.5 The supervisor requires *takāful* intermediaries to disclose to customers, at least:
- the terms and conditions of business between themselves and the customer;
- the relationship they have with the TOs with whom they deal; and
- information on the basis on which they are remunerated where a potential conflict of interest exists.

18.5.1 In addition to disclosing matters relating to intermediaries themselves, intermediaries are required to disclose information on *takāful* products offered to customers (see Standards 19.6 and 19.7).

18.5.2 In setting disclosure requirements, the supervisor may take into account that there are differences in:
- the nature of different *takāful* products;
- the level of sophistication of different customers; and
- the way in which different types of *takāful* are transacted (e.g. differences between commercial and personal [retail] lines).

The nature, timing and detail of disclosures may differ according to the circumstances. Nevertheless, disclosure requirements should provide adequate information to customers, taking into account these factors.

*Terms of Business*

18.5.3 A terms-of-business agreement may be a convenient means by which a *takāful* intermediary can provide important information to a customer and satisfy many of the disclosure requirements. Such a document may include information such as:
- by whom they are licensed and supervised;
- the type of business for which they are licensed;
- whether they are independent or act on behalf of one or more TU;
- information on the basis on which they are remunerated;
- the services provided, including whether they offer products from a full range of TUs, from a limited range or from a single TU;
- charging arrangements for the intermediation services;
- cancellation rights in respect of the intermediation services;
- notification of complaints;
- client money arrangements, including treatment of any return earned on such money;
- confidentiality of information provided; and
• the relevant law governing the agreement.

18.5.4 *Takāful* intermediaries should provide information on terms of business to customers and do so prior to a *takāful* contract being entered into. Where there is an ongoing business relationship between an intermediary and a customer, or once terms-of-business information has initially been provided in the case of policy renewals, the intermediary should review whether reiterating this information is necessary. Further information on terms of business might only be necessary where there are changes to the terms.

18.5.5 When *takāful* cover needs to be arranged immediately, it may not be possible to provide documentation of terms of business at the point of arranging the contract. In such situations, the information may be provided orally and followed up with written documentation within a reasonable period of time.

18.5.6 The supervisor may recommend, or require, that a copy of the terms of business, signed by the customer, is retained as part of the *takāful* intermediary’s records. Where *takāful* is intermediated over the internet, the customer may be required to acknowledge the terms of business before a policy can be proceeded with. Electronic records should also be retained by the intermediary.

*Intermediary Status*

18.5.7 A *takāful* intermediary’s status may provide information to a customer on the extent of products from which recommendations are made and provide an indication of potential conflicts of interest. Where the *takāful* intermediary is only able to select products from a single TO or from a limited range, the customer may wish to carry out their own research to see whether they can obtain better terms or a more suitable product elsewhere in the market.

18.5.8 It is particularly important that *takāful* intermediaries provide customers with information on their relationship with the TOs with whom they deal, specifically whether they are independent or act for one or more TOs, and whether they are authorised to conclude *takāful* contracts on behalf of a TO or not.

18.5.9 Potential conflicts of interest can arise for some intermediaries if the intermediary is part of a wider group or has a financial interest, such as a shareholding, in a TO or insurance group. Such relationships should be disclosed to customers.

18.5.10 Information on the *takāful* intermediary’s status may be provided as part of a terms-of-business agreement or separately. Because of its importance, this information may also be highlighted verbally to the customer.

*Remuneration*
18.5.11  *Takāful* intermediaries are generally remunerated by way of fees and commissions, such as:

- fees paid directly by the customer;
- fees or commissions paid indirectly by the customer, by way of deduction from premiums or funds invested; or
- fees or commissions paid by the TO.

18.5.12 Where TOs' direct sales staff carry out *takāful* intermediation as employees of the TO, they may be salaried as well as receive any applicable commission.

18.5.13 Information on charging structures may be important information to customers. For example, for *takāful* products with an investment element, information on any fees or other costs deducted from the initial amount invested, as well as on fees or commissions deducted from the investment thereafter, will be important.

18.5.14 Information on charging may be provided as part of a terms-of-business agreement, or separately. As fees and commissions vary by product and between product providers, they may need to be provided separately for each product recommended, often by inclusion in product documentation. Given their significance to some types of product, this information may also be highlighted verbally to the customer.

18.5.15 The supervisor may also require that, upon a customer's request to the intermediary, the customer is provided with further information on fees and commissions, including the level of fees and commissions. The intermediary should make the customer aware of their right to request information on fees and commissions. Communication should be clear and not misleading. In view of the impact of fees and commissions upon *takāful* products with an investment element, the supervisor may require that disclosure of fees and commissions is provided to customers prior to contracts being entered into in respect of all such products.

18.5.16 Some forms of remuneration of *takāful* intermediaries potentially lead to a conflict of interest. For example, an intermediary may be tempted to recommend a product which provides higher fees or commissions than another. Potential conflicts of interest for intermediaries may exist in a variety of circumstances (see TCP 19: *Conduct of Business*).

18.5.17 The supervisor should be satisfied that the intermediary has robust procedures in place to identify and avoid, or manage, conflicts of interest, and deliver outcomes aligned with customers' best interests. Where they cannot be avoided, or managed satisfactorily, this would result in the intermediary declining to act. Conflicts of interest may be managed or avoided in different ways depending on the nature and severity of the conflict of interest (see Application Paper on Supervising the Conduct of Intermediaries).
Additionally, circumstances in which conflicts of interest may arise may be covered in the codes of conduct issued by SROs or other professional bodies.

The supervisor should be aware of the use of non-monetary benefits, including, for example, “soft” commissions, offered by TOs to intermediaries. These may include less tangible inducements such as professional support, IT support, or corporate entertainment at sporting or cultural events. Such inducements may lead to conflicts of interest and are less transparent than fees or commissions and also need to be avoided, managed or prohibited as appropriate.

**18.6** The supervisor requires a takāful intermediary who handles client monies to have safeguards in place to protect these funds.

In the course of carrying out its business, a takāful intermediary may:
- receive monies from a client for the payment of premiums to a TO; and/or
- receive monies from a TO in respect of claims or refunded premiums for onward payment to a client.

Some jurisdictions have specific legal requirements in respect of the cash flows where monies are transferred via an intermediary from the customer to the TU, and vice versa, including in determining whether the customer or the TU is at risk in respect of such funds.

Where funds are held at the risk of the client, they may be referred to as “client monies” or “client’s money”. The intermediary should have adequate policies and processes in place for the safeguarding of such funds in the interests of their customers.

In some jurisdictions, premiums are deemed to have been paid to the TO as soon as the customer pays premiums to the intermediary. In these circumstances, the TU, rather than the customer, bears the risk of allowing intermediaries to collect premiums on its behalf.

The supervisor may require that a takāful intermediary's client money policies and processes cover matters such as the following:
- Client accounts are separate and clearly distinguishable from the intermediary’s own bank accounts.
- Client accounts are held with licensed banks within the jurisdiction, or with specified other jurisdictions.
- Client monies related to intermediation of takāful products are held on terms stated to be Shari'ah-compliant.
- No monies other than client monies are held within the account, except in specific circumstances such as to achieve or maintain a minimum balance, to receive a return on the funds held, or to receive commission due to the intermediary.
- Monies are paid into the account promptly.
• Adequate financial systems and controls are maintained, including authorisation of payments from the account.
• Adequate books and records are maintained and subject to audit.
• Reconciliations are performed, and reviewed, on a regular basis.
• Discrepancies on the account are followed up promptly and resolved satisfactorily.
• For each client, payments from a client account are not made before sufficient monies paid into the account have cleared, thus ensuring that any balance held in respect of each client is not negative.
• Income or other return earned on client monies held is treated appropriately.

18.6.6 In the interest of safeguarding clients’ money, it is important that client accounts cannot be used to reimburse creditors of the takāful intermediary.

18.6.7 Where takāful intermediaries operate client accounts, the supervisor may require that the terms and conditions of such accounts are disclosed to their customers, including whether funds held in such accounts are at the risk of clients or of the TU.

18.6.8 The supervisor may require a takāful intermediary to disclose to clients whether client monies held in relation to takāful policies are held in an account with a financial institution that is operated on terms stated to be Sharī‘ah-compliant.

18.7 Where appropriate, the supervisor takes supervisory measures against licensed takāful intermediaries.

18.7.1 The supervisor should initiate measures to prevent or respond to poor conduct or breaches of regulatory requirements by an intermediary, with a view to mitigating adverse outcomes for customers. Where necessary, the supervisor may use sanctions.

18.7.2 The supervisory framework should allow for the exercise of judgment and discretion, and provide flexibility in the use of preventive measures, corrective measure and sanctions.

18.7.3 In some instances, the supervisor may need to work with other relevant authorities or bodies in order to take or enforce supervisory measures or sanctions against an intermediary.

Preventive Measures

18.7.4 Where the supervisor assesses that there may be a material risk of a takāful intermediary breaching supervisory requirements, or a risk to consumer or takāful participant interests in general, it should require takāful intermediaries to take appropriate measures to mitigate both market-wide risks as well as risks from specific entities or individuals.
In this regard, the supervisor may take proactive measures, such as publishing guidance on good practices or warnings to the industry or consumers.

**Corrective Measures**

Where the *takāful* intermediary fails to meet supervisory requirements, or where consumers may otherwise be at risk, the supervisor should require corrective measures to be taken by the *takāful* intermediary. This may occur, for example, where:

- there is evidence of unfair treatment;
- required information is not provided to customers;
- policies and processes are inadequate (particularly where this results in inadequate due diligence work);
- internal controls, file keeping or documentation are inadequate;
- conflicts of interest are not adequately identified or managed; or
- there are concerns over business continuity.

Supervisory measures should apply at either the entity level or the individual level, as appropriate. These may include, for example:

- requiring the implementation of enhanced policies and processes;
- requiring further training;
- restricting business activities;
- suspending or barring specific individuals from engaging in intermediary business or being responsible for the corporate governance of an intermediary organisation; or
- suspending, revoking or not renewing the licence.

**Sanctions**

Where appropriate, the supervisor should impose sanctions on entities or individuals. The range of sanctions may include, for example:

- imposing fines;
- barring individuals from acting in key roles or holding similar roles in the future; or
- requiring remediation, including compensation to *takāful* participants where appropriate.

Sanctions imposed should be commensurate with the nature and severity of the shortcomings. Minor offences may be dealt with through oral or written communications with the intermediary’s management and then followed up, whereas more significant deficiencies may warrant immediate or more significant action.

Jurisdictions should provide due process for an intermediary to appeal supervisory measures.

The supervisor checks that the intermediary is taking the measures required and escalates such measures if its concerns are not being addressed.
18.8.1 The supervisor should review the results of measures that it has required of an intermediary and the effectiveness of the actions taken.

18.8.2 If the action taken by the intermediary does not adequately address the supervisor’s concern, the supervisor should require further measures.

18.8.3 Supervisory measures should be escalated in line with the supervisor’s concern about the intermediary and the risk to consumers.

18.9 The supervisor takes measures against individuals or entities that conduct takāful intermediation without the necessary licence.

18.9.1 The supervisor should have in place mechanisms to identify when unlicensed takāful intermediation is being carried out. Examples of such mechanisms include monitoring media and advertising, review of consumer complaints, and encouraging industry and other stakeholders to notify the supervisor of suspicious activity.

18.9.2 When unlicensed takāful intermediation is identified, the supervisor should act to address the issue. Examples include seeking court orders to require the unlicensed individual or entity to stop the activity, informing law enforcement authorities of criminal and/or civil concerns, and publicising the fact that the individual/entity is not licensed to conduct takāful intermediation.

TCP 19: CONDUCT OF BUSINESS
The supervisor requires that TOs and intermediaries, in their conduct of takāful business, treat customers fairly, both before a contract is entered into and through to the point at which all obligations under a contract have been satisfied.

Introductory Guidance

19.0.1 Requirements for the conduct of takāful business help to:
• protect takāful participants and promote fair consumer outcomes;
• strengthen public trust and consumer confidence in the takāful sector;
• minimise the risk of TUs and intermediaries following business models that are unsustainable or pose reputational risk, thereby complementing the risk management framework of a solvency regime; and
• support a sound and resilient takāful sector by creating level playing fields in terms of the basis on which TUs and intermediaries can compete while maintaining business practices that support the fair treatment of customers.
19.0.2 Fair treatment of customers encompasses achieving outcomes such as:

- developing, marketing and selling products in a way that pays due regard to the interests and needs of customers;
- providing customers with information before, during and after the point of sale that is accurate, clear and not misleading;
- minimising the risk of sales which are not appropriate to customers’ interests and needs;
- ensuring that any advice given is of a high quality;
- dealing with customer claims, complaints and disputes in a fair and timely manner; and
- protecting the privacy of information obtained from customers.

19.0.3 Where any service is held out to be conducted on a Shari‘ah-compliant basis, fair treatment of customers also encompasses due care in ensuring that such assertions have a basis that can be explained and that the TO (in the case of takāful) has processes to ensure that it is maintained.

19.0.4 Where segregation of funds is practised, the fair treatment of customers has additional dimensions, including balancing the interests of those takāful participants in an existing fund with those of potential takāful participants, when determining whether to offer participation in a particular fund.

19.0.5 The distribution of surplus (where this is practised) raises additional considerations as to fair treatment of customers, including both the expectations created when offering takāful contracts with this feature, and decisions as to how any surplus decided to be distributed is allocated between the takāful participants in the fund.

19.0.6 Conduct of business, including business practices, is closely linked with jurisdictions’ tradition, culture, legal regime and the degree of development of the takāful sector. For this reason, supervisory approaches to the conduct of business also tend to vary. Such diversity should be taken into consideration in implementing this TCP, and related standards and guidance material, in order to achieve the outcome of fair treatment of customers. The fair treatment of customers encompasses concepts such as ethical behaviour, acting in good faith and the prohibition of abusive practices.

19.0.7 Requirements for the conduct of takāful business may differ depending on the nature of the customer with whom a TO or intermediary interacts and the type of takāful provided. The scope of requirements for conduct of takāful business should reflect the risk of unfair treatment of customers, taking into account the nature of the customer and the type of takāful provided.

19.0.8 As part of assessing the fulfilment of requirements for conduct of takāful business, the supervisor should consider the consumer outcomes that are being achieved under these requirements. This includes consumer outcomes that arise due to industry-wide – as well as TU-specific – factors.
19.0.9 Supervisors may wish to issue guidelines or rules on their expectations to help TOs and intermediaries achieve fair treatment of customers. In addition, the supervisor could support industry guidelines or best practices with this objective.

19.0.10 Detailed conduct-of-business rules may not be appropriate for retakāful transactions, where benefits under a policy are not affected by the retakāful arrangements (see TCP 13: Retakāful and Other Forms of Risk Mitigation). Nonetheless, this does not relieve TUs and retakāful providers of their duty to provide each other with complete and accurate information.

Respective Responsibilities

19.0.11 The TO has a responsibility for good conduct throughout the takāful life cycle, as it has a fiduciary duty towards takāful participants when managing the takāful funds attributable to them. However, where more than one party is involved in the design, marketing, distribution and policy servicing of takāful products, the good conduct in respect of the relevant service(s) is a shared responsibility of those involved.

19.0.12 Intermediaries typically play a significant role in takāful distribution but may also be involved in other areas. The interface between customers and TUs gives them a key role, and their good conduct in performing the services in which they are involved is critical in building and justifying public trust and confidence in the takāful sector. In the context of takāful, intermediaries have to consider the fair treatment of the potential takāful participants that they advise, in respect of the potential participants’ expectations as to how Shari’ah compliance is ensured in the TU concerned, the financial soundness of any segregated fund in which participation is proposed, any expectations that may be created as to surplus distribution and the rights of participants on insolvency.

19.0.13 TOs sometimes outsource specific processes, such as claims handling, to third parties (including intermediaries). Where a TO outsources processes, the TO should only deal with third parties whose policies, procedures and processes are expected to result in fair treatment of customers; the TO retains ultimately responsibility for those functions.

Cross-Border and Group Considerations

19.0.14 Legislation should provide requirements with which TUs and intermediaries must comply, including foreign TUs and intermediaries selling products on a cross-border basis.

19.0.15 Effective assessment of the quality of conduct of takāful business requires, to a large extent, supervisory consideration of strategies, policies, processes, procedures and controls that apply to the provision of takāful products and services to customers, and which are more easily assessed through supervision at the TU, rather than group, level.
19.0.16 Where TUs are part of an insurance group, the application of appropriate policies and processes on conduct of business should be consistent across the group, recognising local requirements and specificities, and should result in the fair treatment of *takāful* and conventional insurance customers on a group-wide basis. In addition, there are a number of other group-related aspects that are relevant to the supervision of conduct of business by TUs and intermediaries, such as:

- public disclosure by the supervisor of the regulatory requirements in respect of the offering of cross-border *takāful*;
- disclosure to customers of the group to which an underwriter belongs; and
- the potential risks from group entities that could affect policies being sold or administered.

The supervisor should consider the implications arising from group structures in applying the standards of this TCP.

**Supervisory Cooperation**

19.0.17 Supervisors should be aware of the conduct-of-business requirements set by the regulators of other financial services sectors with a view to minimising unnecessary inconsistencies, possible duplication and the potential for regulatory arbitrage.

19.0.18 In some jurisdictions, responsibility for the supervision of TUs or intermediaries is shared between more than one authority, or between different departments within a single authority, with different authorities or departments responsible for conduct and prudential supervision. Where this is the case, the relevant authorities or departments should communicate, and cooperate where possible, to ensure that there is an understanding of all the relevant risks.

19.0.19 The supervisor should also consider having in place adequate coordination arrangements to deal with conduct-of-business issues arising in cross-border business.

**Fair Treatment of Customers**

19.1 The supervisor requires TOs and intermediaries to act with due skill, care and diligence when dealing with customers.

19.1.1 The supervisor should require TOs and intermediaries to have policies and processes in place to achieve this outcome, including taking appropriate measures to ensure that their employees and agents meet high standards of ethics and integrity.

19.1.2 Where segregation of funds is practised, the due skill, care and diligence required of TOs and intermediaries extends also to ensuring fairness between different stakeholders within the TU, as those interests are affected by transactions between them, and the interests of *takāful*
participants, of potential takāful participants and of the TO may differ or conflict. Fair treatment of customers requires consideration of the application of due skill, care and diligence to balance competing interests and avoid unfairness.

19.2 The supervisor requires TOs and intermediaries asserting to customers the Shari‘ah compliance of the products offered, or the operations of the TO or intermediary itself, to have appropriate governance in place to enable the TO or intermediary concerned to justify the assertion.

19.2.1 Shari‘ah compliance of takāful products, and of the operations of the provider, is a specificity of takāful and forms an essential part of the assertion that takāful products are permissible (halal) for Muslims (though takāful products are open to both Muslims and non-Muslims). Consumers seeking assurance of Shari‘ah compliance have to consider the reliability of the assertions of TOs and intermediaries concerning the Shari‘ah compliance of their products and (in the case of TOs, and potentially also of intermediaries) their operations, including the arrangements between the TO and the intermediary distributing the product.

19.2.2 The claim of Shari‘ah compliance raises potential risks regarding the suitability of products and other related issues, particularly where there may be different understandings of Shari‘ah in the jurisdiction, as the consumer may not discover until later that the TO has adopted a different understanding in a material aspect of the contract or operation. This risk may be less if a jurisdiction has a central Shari‘ah authority whose rulings all TOs must observe and compliance with whose rulings the supervisor may be able to observe.

19.2.3 Not all supervisors have a mandate to enforce Shari‘ah compliance, though even those that do not should regard assertions of Shari‘ah compliance as a governance-and-conduct issue and require TOs and, where relevant, intermediaries to have policies and procedures in place to manage the risk of non-compliance. TCP 8: Shari‘ah Governance provides more extensive guidance on this matter in the case of TOs. A proportionate approach should be applied where intermediaries offer both conventional and Islamic insurance products, taking into consideration the extent of the assertions made by the intermediary.

19.2.4 Typical objectives in respect of supervision of TOs might include requiring that such assertions are made only after appropriate (internal or external) scrutiny, and that the TO conducts ongoing monitoring by qualified persons to assess the Shari‘ah compliance of its contracts and operations.

19.2.5 The board of each firm (TU or intermediary, as the case may be) is responsible for discharging the firm’s obligations towards takāful participants, including as regards its conduct of business. Accordingly, supervisors require the board and senior management to put in place appropriate and effective governance structures to ensure that assertions as to Shari‘ah compliance of products, operations or distribution
arrangements are based on reasoned analysis. This responsibility of the board and senior management applies in particular when products are developed or distributed, but also on an ongoing basis.

19.2.6 Matters that a supervisor might consider when forming a view whether the board and senior management have discharged this responsibility, not representing an exhaustive list and to be applied in the context of the jurisdiction concerned, could include the manner in which the board and senior management address:
• maintenance of segregation of funds (where that is practised);
• impermissible risks offered for cover;
• identification and disposition of tainted income;
• selection and management of assets for Shari‘ah compliance;
• acceptance or cession of conventional reinsurance; and
• the risk of riba in transactions.

19.3 The supervisor requires TOs and intermediaries to establish and implement policies and processes on the fair treatment of customers, as an integral part of their business culture.

19.3.1 Supervisors should require TOs and intermediaries to have policies and processes in place to achieve the fair treatment of customers and should monitor whether such policies and processes are adhered to.

19.3.2 Proper policies and processes dealing with the fair treatment of customers are likely to be particularly important with respect to retail customers, because of the greater asymmetry of information that tends to exist between the TO or intermediary and the individual retail customer.

19.3.3 Supervisory requirements with respect to fair treatment of customers may vary depending on the legal framework in place in a particular jurisdiction. The desired outcome of fair treatment of customers may be achieved through a variety of approaches, with some jurisdictions favouring a principles-based set of requirements, some favouring a rules-based approach, and others following some combination of approaches.

19.3.4 Ensuring the achievement of fair outcomes for customers will tend to require that TOs and intermediaries adopt the fair treatment of customers as an integral part of their business culture, and that policies and processes to support this objective are properly embedded in the organisation. Embedding a culture of fair treatment of customers may include the following:
• **Strategy:** Fair treatment of customers should be an objective taken into consideration in the design of the business strategy, product design, product distribution and product performance.
• **Leadership:** Overall responsibility for fair treatment of customers should be at the level of the board and senior management, who should design, implement and monitor adherence to policies and
processes aimed at ensuring that customers are treated fairly. This
sets the tone for the business.

- **Decision making**: All decisions that impact on customers should be
  subject to particular scrutiny in terms of whether they support the fair
treatment of customers.

- **Internal controls**: Monitoring the fair treatment of customers requires
  relevant management information to be identified, collected and
evaluated. Internal reports should include the most useful information
and indicators to allow the board and senior management to
measure the TO’s or intermediary’s performance with respect to fair
treatment of customers. Mechanisms and controls should be
established to ensure that departures from policies and processes,
as well as other situations that jeopardise the interests of customers,
are promptly remedied.

- **Performance management**: Appropriate attention should be paid to
  the recruitment of staff and agents who meet high standards of ethics
  and integrity. Relevant staff should be trained to deliver appropriate
  outcomes in terms of fair treatment of customers. Evaluation of
  performance should include the contribution made to achieving these
  outcomes. There should be appropriate performance management
  consequences for staff who fail to meet these standards.

- **Reward**: Remuneration and reward strategies should take account
  of the fair treatment of customers. Reward structures need to reflect
  quality issues and not encourage or reward the unfair treatment of
  customers. Remuneration structures that create conflicts of interest
  may lead to poor customer outcomes.

19.3.5 Where TUs adopt a practice of distributing surplus arising in a segregated
*takāful* fund to the *takāful* participants in the fund, the supervisor requires
the board and senior management to consider whether the basis of
allocation of distributed surplus between *takāful* participants is fair, as
between the *takāful* participants in the fund, and as between cohorts of
*takāful* participants in the fund over time.

19.3.6 TOs’ and intermediaries’ strategies, policies and processes dealing with
the fair treatment of customers should be made available to the supervisor.
The supervisor should encourage TOs and intermediaries to make relevant
policies and processes publicly available as good practice — in particular,
their claims-handling, complaints-handling and dispute resolution policies
and processes.

19.4 The supervisor requires TOs and intermediaries to avoid or properly manage
any potential conflicts of interest.

19.4.1 In their dealings either with each other or with customers, TOs and
intermediaries may encounter conflicts of interest.

19.4.2 Where conflicting interests compete with duties of care owed to customers,
they can create risks that TOs and intermediaries will not act in customers’
best interests. Conflicts of interest can arise from compensation structures, as well as from other financial and non-financial incentives.

19.4.3 Where compensation structures do not align the interests of the TU and intermediary, including those of the individuals carrying out intermediation activity, with the interests of the customer, they can encourage behaviour that results in unsuitable sales or other breach of the TO's or intermediary's duty of care towards the customer.

19.4.4 Other incentives that may create a conflict of interest include performance targets or performance management criteria that are insufficiently linked to customer outcomes. They also include the soliciting or accepting of inducements where this would conflict with the TO's or intermediary's duty of care towards its customers.

19.4.5 An “inducement” can be defined as a benefit offered to a TO or intermediary, or any person acting on its behalf, incentivising that firm/person to adopt a particular course of action. This may include cash, cash equivalents, commission, goods and hospitality. Where intermediaries who represent the interests of customers receive inducements from TOs, this could result in a conflict of interest that could affect the independence of advice given by them.

19.4.6 As a takāful intermediary interacts with both the customer and the TO, an intermediary is more likely than a TO to encounter conflicts of interest. For a takāful intermediary, examples of where a conflict of interest may occur include:

- where the intermediary owes a duty to two or more customers in respect of the same or related matters – the intermediary may be unable to act in the best interests of one without adversely affecting the interests of the other;
- where the relationship with a party other than the customer influences the advice given to the customer;
- where the intermediary is likely to make a financial gain, or to avoid a financial loss, at the expense of the customer;
- where the intermediary has an interest in the outcome of a service provided to, or a transaction carried out on behalf of, a customer which is distinct from the customer’s interest;
- where the intermediary has significant influence over the customer’s decision (such as in an employment relationship) and the intermediary’s interest is distinct from that of the customer;
- where the intermediary receives an inducement to provide a service to a customer other than the standard or “flat” fee or commission for that service; and
- where the intermediary has an indirect interest in the outcome of a service provided to, or a transaction carried out on behalf of, a customer due to an association with the party that directly benefits (such as soliciting takāful products which are sold together with other financial services in a bancassurance/bancatakāful relationship) and
where such indirect interest is distinct from the customer’s interest (such as the cross-selling or self-placement of business).

19.4.7 Where segregation of funds is practised, the TO may have an interest, different from that of the takāful participant, in the decision as to which fund the takāful participant is allocated, if one or more of the candidate funds is in deficiency and dependent upon qard for its solvency (meaning that surpluses arising on new business must be applied initially to repay qard, which is to the benefit of the qard provider, rather than inuring to the benefit of the takāful participants concerned).

19.4.8 The supervisor should require that TOs and intermediaries take all reasonable steps to identify and avoid or manage conflicts of interest, and communicate these through appropriate policies and processes.

19.4.9 Appropriate disclosure can provide an indication of potential conflicts of interests, enabling the customer to determine whether the sale may be influenced by financial or non-financial incentives. It can thus help in managing conflicts of interest where it empowers consumers to identify and challenge or avoid potentially poor advice or selling that may arise through the conflict of interest. However, managing conflicts of interest through disclosure or by obtaining informed consent from customers has limitations, including where the customer does not fully appreciate the conflict or its implications, and could be seen to place an unreasonable onus on the customer.

19.4.10 Where conflicts of interest cannot be managed satisfactorily, this should result in the TO or intermediary declining to act. In cases where the supervisor may have concerns about the ability of TOs and intermediaries to manage conflicts of interest adequately, the supervisor may consider requiring other measures.

19.5 The supervisor requires TOs and intermediaries to have arrangements in place in dealing with each other to ensure the fair treatment of customers.

19.5.1 The supervisor should require TOs to conduct business only with intermediaries that are licensed, and to verify that the intermediaries under such arrangements have the appropriate knowledge and ability with which to conduct such business.

19.5.2 The supervisor may require TOs to report any significant issues of which they become aware and to have transparent mechanisms for handling complaints against intermediaries. This may include identifying whether particular intermediaries or particular matters are the subject of regular or frequent complaints. Documentation on this will enable TOs to report recurring issues to the supervisor where the matters identified may be relevant to the supervisor’s assessment of the intermediaries concerned.

19.5.3 Supervisory measures to prevent or respond to a breach of regulatory requirements by an intermediary may include action against TOs in the
case of direct sales or where a TO knowingly cooperates with an intermediary that is in breach of its regulatory requirements.

19.5.4 TOs and intermediaries should ensure that written agreements are established in respect of their business dealings with each other, to clarify their respective roles and promote the fair treatment of customers. Such agreements would include, where relevant, respective responsibilities on matters such as:
- product development;
- product promotion;
- the provision of pre-contractual and point of sale information to customers;
- post-sale policy servicing;
- claims notification and handling;
- complaints notification and handling;
- management information and other documentation required by the TO;
- remedial measures; and
- any other matters related to the relationship with customers.

Product Development and Pre-Contractual Stage

19.6 The supervisor requires TOs to take into account the interests of different types of consumers when developing and distributing *takāful* products.

19.6.1 This can be achieved through a product approval approach, a “principles-based” approach, or a combination of both. In a product approval approach, the supervisor requires TOs to submit *takāful* product proposals for supervisory review and approval prior to product launch. In a “principles-based” approach, the onus is placed on the TO’s board and senior management to ensure that products and distribution strategies are developed in accordance with the principles.

19.6.2 Where the supervisor’s mandate does not include supervision of Shari’ah compliance, the product approval basis may not be available as a supervisory approach, so far as concerns the aspect of Shari’ah compliance.

19.6.3 Regardless of the approach taken, the supervisor requires TOs or intermediaries developing and distributing *takāful* products to have in place appropriate and effective governance structures regarding Shari’ah compliance.

19.6.4 In some cases, product development is undertaken by intermediaries on behalf of TUs for whom they act. In such cases, the intermediaries involved are responsible for taking customers’ interests and needs into account in performing this work. Nevertheless, the TO should retain oversight of, and remains accountable for, the development of its products and its distribution strategies.

*Product Approval Approach*
19.6.5 Where supervisors have the power to approve contract conditions or pricing, the approval process should balance the protection of customers against the potential benefits to customers of innovation and choice in takāful products. For example, supervisory approval of contract conditions or pricing is likely to be more appropriate in certain circumstances, such as where the TO is dealing with less financially capable or vulnerable customers, where products are new to the market or complex, or where takāful contracts are required by law, such as automobile liability takāful or health takāful.

19.6.6 In such situations, the supervisor may review products for compliance with things such as:

• mandated policy limits;
• coverage of specified risks, procedures or conditions;
• absence of prohibited exclusions; and
• compliance with specifically required policy language.

19.6.7 Where the supervisor’s mandate includes supervision of Shari`ah compliance, the supervisor may also review products for compliance with features relevant to Shari`ah compliance as understood in the jurisdiction – for example:

• exclusion of coverage of impermissible risks;
• limitation to permissible assets in funds attributable to takāful participants;
• absence of riba in the transaction; and
• appropriate application of beneficiary requirements in the contract (in the case of family takāful).

Principles-Based Approach

19.6.8 Where supervisors follow a more principles-based approach, supervisors may issue guidance in terms of what is expected of TUs and intermediaries. This may include the following:

• Development of products and distribution strategies should include the use of adequate information to assess the needs of different consumer groups.
• Product development (including a product originating from a third party) should provide for a thorough assessment of the main characteristics of a new product and of the related disclosure documents by every appropriate department of the TO.
• Before bringing a product or service to the market, the TO should carry out a diligent review and testing of the product in relation to its business model, the applicable laws and regulations, and its risk management approach. In particular, the policies, procedures and controls put into place should enable the TO to:
  o offer a product that delivers the reasonably expected benefits;
• target the consumers for whose needs the product is likely to be appropriate, while preventing, or limiting, access by consumers for whom the product is likely to be inappropriate;
• ensure that distribution methods are appropriate for the product, particularly in light of the legislation in force and whether or not advice should be provided;
• assess the risks resulting from the product by considering, among other things, changes associated with the environment or stemming from the TU’s policies that could harm customers; and
• monitor a product after its launch to ensure it still meets the needs of target customers, assess the performance of the various methods of distribution used with respect to sound commercial practices and, if necessary, take the necessary remedial action.

• TOs should provide relevant information to intermediaries to ensure that they understand the target market (and thus reduce the risk of mis-selling), such as information related to the target market itself, as well as the characteristics of the product.
• The intermediary should, in return, provide information to the TO on the types of customers to whom the product is sold and whether the product meets the needs of that target market, in order to enable the TO to assess whether its target market is appropriate and to revise its distribution strategy for the product, or the product itself, when needed.

19.6.9 Supervisors may require TOs to submit specific information relating to the manner in which the development of takāful products complies with the legislated principles at any time, including prior to the launch of the product (pre-notification).

19.7 The supervisor requires TOs and intermediaries to promote products and services in a manner that is clear, fair and not misleading.

19.7.1 The TO should be responsible for providing promotional material that is accurate, clear and not misleading, not only to customers but also to intermediaries who may rely on such information.

19.7.2 Before a TO or intermediary promotes a takāful product, it should take reasonable steps to ensure that the information provided is accurate, clear and not misleading. Procedures should provide for an independent review of promotional material intended for customers other than by the person or organisation that prepared or designed it. For example, where promotional material is developed by an intermediary on behalf of a TU, the TO should verify the accuracy of promotional material before it is used.

19.7.3 Where takāful contracts include entitlement to distribution of surplus arising in the segregated fund to which the contract is attributed (rather than alternative applications of such surplus such as retaining it as accumulated reserves of the fund, assigning it to charitable purposes or using it to
support future levels of takāful contribution), care is needed in reflecting this product feature when promoting the product. Illustrations should be clear as to the circumstances under which distribution may occur, and the circumstances that may prevent distribution.

19.7.4 Where the possibility of surplus distribution is promoted as a selling point, expectations of distribution may persist even when there is no surplus. Where the fund is in deficiency (i.e. is dependent on qarḍ to meet capital requirements and absorb losses on a temporary basis), failure to make clear to potential takāful participants where surpluses arising on new business must be applied first against the qarḍ has the potential to mislead potential takāful participants and result in unfair treatment.

19.7.5 If a TO or intermediary becomes aware that the promotional material is not accurate and clear or is misleading, it should:
- inform the TO or intermediary responsible for that material;
- withdraw the material; and
- notify any person that it knows to be relying on the information as soon as reasonably practicable.

19.7.6 In addition, to promote products in a fair manner, the information provided by a TO or intermediary should:
- be easily understandable;
- accurately identify the product provider;
- be consistent with the coverage offered;
- be consistent with the result reasonably expected to be achieved by the customers of that product;
- state prominently the basis for any claimed benefits and any significant limitations; and
- not hide, diminish or obscure important statements or warnings.

19.7.7 The information should, where consumers are also able to purchase conventional insurance products, make clear in what respects the product differs from conventional insurance products covering the same risk.

19.8 The supervisor requires TOs and intermediaries to provide timely, clear and adequate pre-contractual and contractual information to customers.

19.8.1 The TO or intermediary should take reasonable steps to ensure that a customer is given appropriate information about a product in order that the customer can make an informed decision about the arrangements proposed. Such information is also useful in helping customers understand their rights and obligations after contract completion.

19.8.2 Where TOs use intermediaries for the distribution of takāful products, the TO should be satisfied that the intermediaries involved are providing information to customers in a manner that will assist them in making an informed decision.

Timing of the Provision of Information to Customers
19.8.3 Customers should be appropriately informed before and at the point of sale. Information should enable an informed decision to be made by the customer before entering into a contract. In determining what is “timely”, a TO or intermediary should consider the importance of the information to the customer’s decision-making process and the point at which the information may be most useful.

Clear Delivery of Information to Customers

19.8.4 Information should be provided in a way that is clear, fair and not misleading. Wherever possible, attempts should be made to use plain language that can easily be understood by the customer.

19.8.5 Mandatory information should be prepared in written format, on paper or in a durable and accessible medium (e.g. electronic).

19.8.6 Focus should be on the quality rather than quantity of information, as there is a risk that if the disclosure becomes too voluminous then the customer may be less likely to read the information.

19.8.7 The quality of disclosure may also be improved by the introduction of a standardised format for disclosure (such as a product information sheet), which will aid comparability across competing products and allow for a more informed choice. Standard formats should be tested to ensure that they help understandability.

19.8.8 There is likely to be an enhanced need for clear and simple disclosure for more complex or “bundled” products that are difficult for consumers to understand, such as packaged retail takāful-based investment products, particularly regarding the costs, risks involved and performance.

19.8.9 TOs and intermediaries should be able to demonstrate to the supervisor that customers have received information necessary to understand the product.

Adequacy of Information Provided to Customers

19.8.10 The information provided should be sufficient to enable customers to understand the characteristics of the product they are buying and to help them understand whether and why it may meet their requirements.

19.8.11 The level of information required will tend to vary according to matters such as:

- the knowledge and experience of a typical customer for the policy in question;
- the policy terms and conditions, including its main benefits, exclusions, limitations, conditions and duration;
- the policy’s overall complexity;
• whether the policy is bought in connection with other goods and services; and
• whether the same information has been provided to the customer previously and, if so, when.

19.8.12 While the level of information required may vary, it should include information on key features, such as:
• the name of the TU, its legal form and, where relevant, the group to which it belongs;
• the type of takāful contract on offer, including the policy entitlements;
• the operating model of the TU, including the structure of funds, in relation to the particular type of takāful in question;
• a description of the risk insured by the contract and of the excluded risks;
• a breakdown of the contractual payments under the contract, including the calculation of any fees or profit shares paid by the takāful participant or by the relevant takāful fund to the TO;
• rights to, or policies on, any distribution of surplus;
• the level of the takāful contribution, the due date and the period for which the takāful contribution is payable, the consequences of late or non-payment, and provisions for takāful contribution reviews;
• the type and level of charges to be deducted from or added to the quoted takāful contribution, and any charges to be paid directly by the customer;
• when the takāful cover begins and ends;
• the allowable expenses charged (where segregation of funds is practised) to the takāful fund, including the method by which any shared costs are allocated between funds; and
• prominent and clear information on significant or unusual exclusions or limitations. A significant exclusion or limitation is one that would tend to affect the decision of consumers generally to enter into the contract. An unusual exclusion or limitation is one that is not normally found in comparable contracts. In determining what exclusions or limitations are significant, a TO or intermediary should, in particular, consider the exclusions or limitations that relate to the significant features and entitlements of a policy and factors which may have an adverse effect on the entitlements payable under it. Examples of significant or unusual exclusions or limitations may include:
  o deferred payment periods;
  o exclusion of certain conditions, diseases or pre-existing medical conditions;
  o moratorium periods;
  o limits on the amounts of cover;
  o limits on the period for which compensation will be paid;
  o restrictions on eligibility to claim, such as age, residence or employment; and
  o excesses.
19.8.13 Where a policy is bought in connection with other goods or services, the premium should be disclosed separately from any other prices. It should be made clear whether buying the policy is compulsory and, if so, whether it can be purchased elsewhere.

19.8.14 Where the contract includes any right of the TO to make calls on the takāful participants, or obligations on the takāful participant to pay such calls, in the event that the assets in the fund to which their contracts are attributed are insufficient to meet the liabilities of the fund, or includes any right of the TO to cover any fund-level capital requirement, the TO must emphasise to the takāful participants the risk that such calls will be made. Contracts with this feature should not be marketed to customers that do not give informed consent to the presence of the feature in the contract and that are able and willing to meet any such call in the event of a fund deficit or deficiency.

19.8.15 Where the contract includes any rights to distribution of surplus on a takāful fund, the TO discloses information on the financial condition of the fund in question as at the most recent date for which financial information has been published, including:
- the level of surplus (if any) within the fund;
- the capital resources (if any) required to be maintained within the fund; and
- the amount (if any) of qarḍ requiring repayment before surplus may be distributed to takāful participants.

19.8.16 At the level of each participants’ investment fund to which all or part of the product is proposed to be attributed, the TO/RTO should adequately describe in clearly understandable language its:
- investment objective;
- investment strategy;
- strategic asset allocation; and
- performance benchmark (to aid in comparing targeted performance to actual periodic performance).

19.8.17 For investment-based takāful products, information on investment performance is generally provided. Where this includes an indication of past, simulated or future performance, the information should include any limits on upside or downside potential and a prominent warning that past performance is not a reliable indicator of future performance.

19.8.18 A helpful means to ensure that accurate and comprehensible information is provided to the customer is a product information sheet containing information on key product features that are of particular significance to the conclusion or performance of the takāful contract. The product information sheet should be clearly identified as such, and it should be pointed out to the customer that the information is not exhaustive. In so far as the information concerns the content of the contract, reference should be made as appropriate to the relevant provisions of the contract or to the general policy conditions underlying the contract. TOs, and intermediaries where
they are involved, should consider the use of evaluation by third parties, such as consumer testing, in developing product information sheets in order to ensure their understandability.

Disclosure of Rights and Obligations

19.8.19 Retail customers, in particular, often have only limited knowledge about the legal rights and obligations arising from a takāful contract. Before a takāful contract is concluded, the TO or intermediary should inform a retail customer on matters such as:

• general provisions, including applicable law governing the contract;
• obligation to disclose material facts, including prominent and clear information on the obligation on the customer to disclose material facts truthfully. Ways of ensuring a customer knows what they must disclose include explaining the duty to disclose all circumstances material to a policy and what needs to be disclosed, as well as the consequences of any failure to make such a disclosure. Alternatively, rather than an obligation of disclosure, the customer may be asked clear questions about any matter material to the TO;
• obligations to be complied with when a contract is concluded and during its lifetime, as well as the consequences of non-compliance;
• obligation to monitor cover, including a statement, where relevant, that the customer may need to review and update the cover periodically to ensure it remains adequate;
• right to cancel, including the existence, duration and conditions relating to the right to cancel. If there are any charges related to the early cancellation or switching of a policy, this should be prominently disclosed;
• right to claim benefits, including conditions under which the takāful participant can claim and the contact details to notify a claim;
• obligations on the customer in the event of a claim; and
• right to complain, including the arrangements for handling takāful participants’ complaints, which may include a TO’s internal claims dispute mechanism or the existence of an independent dispute resolution mechanism.

19.8.20 Where entitlements under a takāful contract entered into by a retail customer are, under the terms of the contract, required to be distributed in accordance with Sharī`ah rules and principles by a claimant who acts as executor, parent, guardian or assignee of the person(s) otherwise entitled, the TO or intermediary should draw the customer’s attention to the requirements of the contract in this respect.

19.8.21 Where applicable, the customer may also be provided with information on any takāful participant protection scheme or compensation scheme in the case of a TU not being able to meet its liabilities, and any limitations on such a scheme.
If the takāful undertaking is a foreign TU, the TO or intermediary should be required to inform the customer, before any commitment is entered into, of details such as:

• the home authority responsible for the supervision of the TU;
• the jurisdiction in which the head office or, where appropriate, the branch with which the contract is to be concluded is situated; and
• the relevant provisions for making complaints or independent dispute resolution arrangements.

The foregoing paragraph applies also in the case of a takāful window of which the host insurer is a foreign insurer.

Disclosure Specific to Internet Sales or Sales through Other Digital Means

TUs and intermediaries are increasingly using digital distribution channels to market and sell takāful products, including internet and mobile phone solutions.

It may be more difficult for consumers to understand from which location the TO or intermediary is operating, their identity, and by whom and where they are licensed. This may especially be the case where more than one TU or intermediary is involved in the distribution chain.

In conducting takāful business through digital channels, TUs and intermediaries should take into account the specificities of the medium used, and use appropriate tools to ensure that customers receive timely, clear and adequate information that helps their understanding of the terms on which the business is conducted.

The supervisor should require that TOs and intermediaries which offer takāful products through digital means disclose relevant business and contact information (e.g. on their website), such as:

• the address of the TO’s head office and the contact details of the supervisor responsible for the supervision of the head office;
• contact details of the TO, branch or intermediary, and of the supervisor responsible for the supervision of the business, if different from the above;
• the jurisdictions in which the TO or intermediary is legally permitted to provide takāful;
• procedures for the submission of claims and a description of the claims-handling procedures; and
• contact information on the authority or organisation dealing with dispute resolution and/or consumer complaints.

The supervisor should apply to digital takāful activities requirements on transparency and disclosure so as to provide an equivalent level of protection to customers as those applied to insurance business conducted through non-digital means.
Where customers receive advice before concluding a takāful contract, the supervisor requires that the advice provided by TOs and intermediaries takes into account the customer's disclosed circumstances.

19.9.1 Advice goes beyond the provision of product information and relates specifically to the provision of a personalised recommendation on a product in relation to the disclosed needs of the customer.

19.9.2 The TO or the intermediary should make it clear to the customer whether advice is provided or not.

19.9.3 TOs and intermediaries should seek the information from their customers that is appropriate for assessing their takāful demands and needs, before giving advice. This information may differ depending on the type of product and may, for example, include information on the customer’s:
- financial knowledge and experience;
- needs, priorities and circumstances;
- ability to afford the product; and
- risk profile.

19.9.4 The supervisor may wish to specify particular types of policies or customers for which advice is not required to be given. Typically, this may include simple-to-understand products, products sold to customer groups that have expert knowledge of the type of product or, where relevant, mandated coverage for which there are no options. Even if no advice is given, the supervisor may require the TO or intermediary to take into account the nature of the product and the customer’s disclosed circumstances and demands and needs.

19.9.5 In cases where advice would normally be expected, such as complex or investment-related products, and the customer chooses not to receive advice, it is advisable that the TO or intermediary retains an acknowledgment by the customer to this effect.

19.9.6 The basis on which a recommendation is made should be explained and documented, particularly in the case of complex products and products with an investment element. All advice should be communicated in a clear and accurate manner that is comprehensible to the customer. Where advice is provided, this should be communicated to the customer in written format, on paper or in a durable and accessible medium, and a record kept in a “client file”.

19.9.7 The TO or intermediary should retain sufficient documentation to demonstrate that the advice provided was appropriate, taking into account the customer’s disclosed circumstances.

19.9.8 In addition, TOs and intermediaries should review the “client files” of those under their responsibility to exercise control after the fact on the quality of the advice given, take any necessary remedial measures with respect to
the delivery of advice and, if applicable, be in a position to examine fairly any complaints submitted to it.

19.9.9 There should be a responsibility of the TO and the intermediary to promote quality advice. In order to ensure the delivery of quality advice, the TO and intermediary should, in particular, establish continuous training programmes that allow the persons giving advice to:

- keep abreast of market trends, economic conditions, innovations and modifications made to the products and services;
- maintain an appropriate level of knowledge about their industry segment, including the characteristics and risks of the products and services;
- know the relevant fatawā, Shari`ah rules and principles, and applicable legal and regulatory requirements;
- know the requirements for the communication of information regarding the products and services and for appropriate disclosure of any situation liable to compromise the impartiality of the advice given or limit such advice; and
- be familiar with the documentation regarding the products and services and answer reasonably foreseeable questions.

This could include TOs providing training to their sales staff and to intermediaries in respect of specific products.

Policy Servicing

19.10 The supervisor requires TUs to:

- service policies appropriately through to the point at which all obligations under the policy have been satisfied;
- disclose to the takāful participant information on any contractual changes during the life of the contract; and
- disclose to the takāful further relevant information, depending on the type of takāful product.

19.10.1 For the purposes of this standard, “takāful participant” refers only to the party to whom a contract of takāful is issued by a TU (as opposed to the broader IFSB definition).

19.10.2 Supervisors should require TUs to satisfy obligations under a policy in an appropriate manner and in accordance with the contractually agreed terms and legal provisions. This should include fair treatment in the case of switching between products or early cancellation of a policy. To enable them to do so, TOs should maintain a relationship with the customer throughout the policy life cycle.

19.10.3 Although ongoing policy servicing is traditionally seen as primarily the responsibility of the TO, intermediaries are often involved, particularly where there is an ongoing relationship between the customer and the intermediary. The TO should remain ultimately responsible for servicing
policies throughout their life cycle, and for ensuring that intermediaries have appropriate policies and processes in place in respect of the policy servicing activities that they perform on the TU’s behalf.

19.10.4 Policy servicing includes the provision of relevant information to customers throughout the life of the policy.

Information on the TU

19.10.5 Information to be disclosed by the TO to the takāful participant includes:
- any change in the name of the TU, its legal form, or the address of its head office and any other offices as appropriate;
- any acquisition by another undertaking resulting in organisational changes as far as the takāful participant is concerned; and
- where applicable, information on a portfolio transfer (including takāful participants’ rights in this regard).

Information on Terms and Conditions

19.10.6 TOs should provide evidence of cover (including policy inclusions and exclusions) promptly after inception of a policy.

19.10.7 Information to be provided on an ongoing basis, including changes in policy terms and conditions or amendments to the legislation applicable to the policy, will vary by type of policy and may cover, for example:
- main features of the takāful benefits – in particular, details on the nature, scope and due dates of benefits payable by the TU;
- the total cost of the policy, expressed appropriately for the type of policy, including all taxes and other cost components; premiums should be stated individually if the takāful relationship comprises several independent takāful contracts or, if the exact cost cannot be provided, information provided on its basis of calculation to enable the takāful participant to verify the cost;
- any changes to the cost structure, if applicable, stating the total amount payable and any possible additional taxes, fees and costs not levied via or charged by the TU, as well as any costs incurred by the takāful participant for the use of communication methods if such additional costs are chargeable;
- duration of the contract, terms and conditions for (early) termination of the contract and contractual consequences;
- means of payment of premiums and duration of payments;
- premiums for each benefit, both main benefits and supplementary benefits;
- information to the takāful participant about the need to report depreciation/appreciation;
- information to the takāful participant about other unique circumstances related to the contract;
- information on the impact of a switch option of a takāful contract;
- information on a renewal of the contract; and
• information on the ongoing suitability of the product, if such a service is provided by the TO or intermediary.

19.10.8 Additional information provided to the *takāful* participants regarding products with an investment element should at least include:
• overall investment strategy and objectives for the investment fund concerned, including explanatory notes on the underlying principles for asset allocation and investment performance;
• the current surrender value;
• *takāful* contributions paid to date; and
• for unit-linked family *takāful*, a report from the investment firm (including performance of underlying funds, changes of investments, investment strategy, number and value of the units and movements during the past year, administration fees, taxes, charges and current status of the account of the contract).

19.10.9 Where there are changes in terms and conditions, the TO should notify the *takāful* participant of their rights and obligations regarding such changes and obtain the *takāful* participant’s consent as appropriate.

19.11 The supervisor requires TOs to handle claims in a timely, fair and transparent manner.

19.11.1 Supervisors should require that TOs have fair and transparent claims-handling and claims dispute resolution policies and processes in place.

*Claims Handling*

19.11.2 TOs should maintain written documentation on their claims-handling procedures, which include all steps from the claim being raised to its settlement. Such documentation may include expected time frames for these steps, which might be extended in exceptional cases.

19.11.3 Claimants should be informed about procedures, formalities and common time frames for claims settlement.

19.11.4 Claimants should be given information about the status of their claim in a timely and fair manner.

19.11.5 Claim-determinative factors such as depreciations, discounting or negligence should be illustrated and explained in comprehensive language to claimants. The same applies where claims are denied in whole or in part.

19.11.6 Sometimes intermediaries serve as an initial contact for claimants, which may be in the common interest of the *takāful* participant, intermediary and TU.
A fair claims assessment process requires avoidance of conflicts of interest, as well as appropriate competence and ongoing training of the staff involved.

Competence requirements for claims assessment differ depending on the type of takāful policy and generally include technical and legal expertise.

Claims Disputes

In the course of claims settlement, a dispute may arise between the claimant and the TU on the claims settlement amount or coverage. Staff handling claims disputes should be experienced in claims handling and be appropriately qualified.

Dispute resolution procedures should follow a balanced and impartial approach, bearing in mind the legitimate interests of all parties involved. Procedures should avoid being overly complicated, such as having burdensome paperwork requirements. Decisions should include the reasoning in clear language relating closely to the specific disputable issues.

Supervisors may encourage TOs to have mechanisms in place to review claims disputes within the TO to promote fair play and objectivity in the decisions.

Outsourcing

If any of the claims-handling processes are outsourced in part or in full, then supervisors should require TOs to maintain close oversight and ultimate responsibility for the provision of fair and transparent claims handling and claims dispute resolution.

The supervisor requires TOs and intermediaries to handle complaints in a timely and fair manner.

A complaint can be defined as an expression of dissatisfaction about the service or product provided by a TO or intermediary. It may involve, but should be differentiated from, a claim and does not include a pure request for information.

TOs and intermediaries should establish policies and processes for dealing in a fair manner with complaints which they receive. These should include keeping a record of each complaint and the measures taken for its resolution.

TOs and intermediaries should make information on their policies and processes on complaints handling available to customers.
TOs and intermediaries should respond to complaints without unnecessary delay; complainants should be kept informed about the handling of their complaints.

TOs and intermediaries should analyse the complaints they receive to identify trends and recurring risks. Analysis of what leads to individual complaints can help them to identify, and enable them to correct, common root causes.

TOs should analyse complaints that they receive against intermediaries in respect of products that the intermediaries have distributed on their behalf, to enable them to assess the complete customer experience and identify any issues that need to be addressed.

Supervisors may choose to have their own complaints monitoring systems in place in order to benefit from the findings resulting from takāful participant complaints.

Some TOs and intermediaries may decide to establish a mechanism to review complaints, in order to ensure respective policies on complaints handling are in place.

**Independent Dispute Resolution Mechanisms**

It is important that there are simple, affordable, easily accessible and equitable mechanisms in place, independent of TUs and intermediaries, to resolve disputes that have not been resolved by the TU or intermediary. Such mechanisms, collectively referred to here as “independent dispute resolution (IDR) mechanisms”, may vary across jurisdictions and may include mediation, an independent review organisation or an ombudsman. These are out-of-court mechanisms.

IDR mechanisms often operate on the basis of a code of procedure, or in some cases legislative rules, and may be restricted to retail takāful participants. They are sometimes free of charge for such takāful participants. Decisions are generally non-binding for the takāful participant but may be binding for the TU or intermediary within certain limits. As consumers may still avail themselves of court processes if the dispute is not satisfactorily resolved, it is usually agreed that the period of limitation is suspended during an IDR procedure.

Mediators serving IDR mechanisms should meet high standards of professional knowledge, integrity and competence. This would be evidenced, for example, where the mediator is qualified to exercise the functions of a judge and is well grounded in the field of takāful or insurance law. Although IDR mechanisms are usually financed by TUs and/or intermediaries, their mediators must be independent from them. Doubts over independence may be expected if the mediator:

- is subject to instructions from TUs/intermediaries;
- is a former employee of a TO/intermediary; or
simultaneously performs other functions which could affect their independence.

19.13 **The supervisor requires TOs, TUs and intermediaries to have policies and processes for the protection and use of information on customers.**

19.13.1 TUs and intermediaries collect, hold, use or communicate to third parties information on their customers in the course of their business. It is important that they have in place policies and processes on the appropriate use and, in the case of personal information, the privacy of such data.

*Protecting the Privacy of Personal Information*

19.13.2 Significant amounts of the information collected, held or processed represent customers’ financial, medical and other personal information. Security over such information is extremely important, regardless of the format of the information (e.g. whether physical or electronic). Hence, safeguarding personal information on customers is one of the key responsibilities of the financial services industry.

19.13.3 Legislation identifies the provisions relating to privacy protection under which TOs or TUs and intermediaries are allowed to collect, hold, use or communicate personal information on customers to third parties. Generally, the legislation also identifies who is the competent authority.

19.13.4 Although data protection laws vary from jurisdiction to jurisdiction, TOs and TUs and intermediaries should have a clear responsibility to provide their customers with a level of comfort regarding the security of their personal information.

19.13.5 In view of the sensitivity of private information and the risks to consumers and to the *takāful* sector in the event of failures to protect the privacy of such information, the supervisor should be satisfied that TOs, TUs and intermediaries have sufficient safeguards in place to protect the privacy of personal information on customers. To achieve this, the supervisor should require TOs, TUs and intermediaries to have appropriate policies and processes in place. Such policies and processes should seek to embed the importance of protecting the privacy of personal information within the organisation, as well as provide appropriate management of the risks. Examples of areas that may be covered include:

- ensuring that the board and senior management are aware of the challenges relating to protecting the privacy of personal information on customers;
- demonstrating that privacy protection is part of the organisation’s culture and strategy, through measures such as providing training to employees that promotes awareness of internal and external requirements on this subject;
- implementing policies, procedures and internal control mechanisms that support the objectives of protecting the privacy of personal
information on customers and assess the risks associated with potential failure to protect the privacy of personal information;
• assessing the potential impact of new and emerging risks that could threaten the privacy of personal information, such as the risk of cyber-attacks, and taking appropriate steps to mitigate these through measures such as internal controls, technology and training; and
• determining the response measures that may be needed where a failure to protect the privacy of personal information occurs, including matters such as timely notification to affected customers and competent authorities.

In assessing policies and processes to protect the privacy of personal information on customers, depending on the jurisdiction, the supervisor may need to liaise with the relevant competent authority.

**Protection Against the Misuse of Customer Information**

19.13.6 TOs, TUs and intermediaries use personal and other information on customers for a variety of purposes within the course of business that include, among other things, product development, marketing, product pricing and claims management.

19.13.7 The supervisor should not allow TOs, TUs and intermediaries to use customer information that they collect and hold in a manner that results in unfair treatment. TOs and intermediaries should have appropriate policies and processes in place. The measures that the supervisor should expect such policies and processes to cover may include:
• ensuring that the appropriate technology is available and in place to manage adequately the personal and other information a TO or intermediary is holding on a customer;
• implementing policies and processes relating to the use of data, ensuring that the data collected are not used in an unfair manner, including when processed through algorithms or other technologies;
• ensuring that such policies and processes provide that customer data will not be abused to circumvent rules on prohibitions on aggressive marketing practices or discrimination;
• ensuring that customers have a right to access and, if needed, to correct data collected and used by TOs, TUs and intermediaries; and
• ensuring that group structures are not abused to circumvent prohibitions on the sharing of personal information.

In assessing policies and processes to prevent the use of customer information in a manner that results in unfair treatment, depending on the jurisdiction, the supervisor may need to liaise with the relevant competent authority.

**Outsourcing**

19.13.8 TOs, TUs and intermediaries should be aware of outsourcing risk, especially when the outsourcing agreement is reached with firms in another jurisdiction. TOs, TUs and intermediaries should ensure that the
firms to which they outsource processes have adequate policies and processes in place for the protection and use of private information on customers they have in their records.

**Data Access in the Event of Reorganisation**

19.13.9 All the necessary data required in the event of restructuring, resolution and liquidation should, subject to data protection requirements, be accessible and readable at the TU’s or intermediary’s domicile at any time. This includes all customer-related data, such as claims and policy data.

**Information Supporting Fair Treatment**

19.14 The supervisor publicly discloses information that supports the fair treatment of customers.

19.14.1 The supervisor should publish the takāful participant protection arrangements that are in place for takāful contracts sold within its jurisdiction and TUs subject to its supervision, and confirm the position of takāful participants dealing with TUs and intermediaries not subject to oversight or supervision within its jurisdiction.

19.14.2 The supervisor should give information to the public about whether and how local legislation applies to the cross-border offering of takāful, such as through digital channels.

19.14.3 The supervisor should issue warning notices to consumers when necessary in order to avoid transactions with TUs or intermediaries that are unlicensed or subject to a suspended or revoked licence.

19.14.4 The supervisor should publish information that promotes consumers’ understanding of takāful contracts as well as steps that consumers can take to protect themselves and make informed decisions.

19.14.5 The supervisor should have requirements regarding the public disclosure by TOs of information on their TUs’ business activities, performance and financial position, in order to enhance market discipline, consumer awareness, and understanding of the risks to which TUs are exposed (see TCP 20: Public Disclosure).

19.14.6 Where segregation of funds is practised, the supervisor’s requirements as to public disclosure by TOs include requirements to disclose publicly the financial position of each takāful fund to which takāful contracts are or may be attributed, including disclosure of the amount of any qard advanced to the fund and the financial position of the fund before taking account of any such qard advanced or of any amounts of own funds not advanced to the fund but eligible as capital resources of the fund.
TCP 20: PUBLIC DISCLOSURE

The supervisor requires TOs to disclose relevant and comprehensive information on a timely basis in order to give takāful participants and market participants a clear view of their business activities, risks, performance and financial position.

Introductory Guidance

20.0.1 Public disclosure of material information is expected to enhance market discipline by providing meaningful and useful information to takāful participants to make decisions on insuring risks with the TU, and to market participants (which includes existing and potential investors, lenders and other creditors) to make decisions about providing resources to the TU.

20.0.2 Where the takāful operating model used involves segregation of funds, the disclosure of information for each segregated fund is relevant to the information needs of those stakeholders whose interest in a TU is specific to one or more of those funds (e.g. a current or prospective takāful participant in that fund). In these cases, the disclosure of information on an aggregated or consolidated basis is unlikely to be adequate for the needs of users who are reliant upon public disclosures.

20.0.3 Accordingly, in standards and guidance material relating to this TCP, supervisors of TUs operating under a segregated account model should consider the need for disclosures at segregated fund level where this is relevant, and in any case where it is necessary in order to provide meaningful information to current or prospective takāful participants.

20.0.4 So far as practicable, information should be presented in accordance with any applicable jurisdictional, international standards or generally accepted practices so as to aid comparisons between TUs.

20.0.5 In setting public disclosure requirements, the supervisor should take into account the information provided in general purpose financial statements and complement it as appropriate. The supervisor should note that TUs which provide public general purpose financial reports may largely comply with jurisdictional disclosure standards that are reflective of this TCP. Where a supervisor publishes on a regular and timely basis information received from TUs, the supervisor may decide that those TUs do not need to publicly disclose that same information.

20.0.6 To the extent that there are differences between the methodologies used in regulatory reporting, general purpose financial reporting and any other items for public disclosure, such differences should be explained and reconciled where possible.

20.0.7 The supervisor’s application of disclosure requirements will depend on the nature, scale and complexity of TUs. For example, it may be overly
burdensome for a small, private TU to meet the same requirements developed for large, publicly traded TUs. While disclosure requirements may vary, the outcome should promote market discipline and provide *takāful* participants and market participants with adequate information for their needs.

20.0.8 Additionally, the supervisor may decide not to apply disclosure requirements if there is no potential threat to the financial system and no public interest need for disclosure, and no legitimately interested party is prevented from receiving information. It is expected that such situations would be exceptional, but could be more relevant for certain types of TUs (e.g. captive TUs).

20.0.9 Public disclosure may include a description of how information is prepared, including methods applied and assumptions used. Disclosure of methods and assumptions may assist *takāful* participants and market participants in making comparisons between TUs. Accounting and actuarial policies, practices and procedures differ not only between jurisdictions but also between TUs within the same jurisdiction. Meaningful comparisons can be made only where there is adequate disclosure of how information is prepared.

20.0.10 Similarly, meaningful comparisons from one reporting period to another can be made only if the reader is informed of how the methods and assumptions of preparation have changed and, if practicable, of the impact of that change. Changes over time may not be seen as arbitrary if the reasons for changes in methods and assumptions are explained. If a TU uses methods and assumptions in the preparation of information which are consistent from period to period, and discloses these, it will assist in the understanding of trends over time.

20.0.11 Where changes in methods and assumptions are made, the nature of such changes, the reason for them and their effects, where material, should be disclosed. It may be helpful if information is presented in a manner that facilitates the identification of patterns over time, including providing comparative or corresponding figures from previous periods (e.g. by presenting loss triangulations).

20.0.12 In establishing disclosure requirements for its jurisdiction, the supervisor should consider the need for disclosures that deliver key information rather than unnecessary volumes of data. Excessive disclosure requirements will not lead to effective disclosures for *takāful* participants and market participants and will be burdensome for TUs.

20.0.13 In establishing disclosure requirements, the supervisor should take into account proprietary and confidential information. Proprietary information comprises information on characteristics and details of, for example, *takāful* products, markets, distribution, and internal models and systems that could negatively influence the competitive position of a TU if made available to competitors. Information about *takāful* participants and
covered parties is usually confidential under privacy legislation or contractual arrangements.

20.0.14 Proprietary and confidential information affects the scope of the required disclosure of information by TOs about their customer base and details on internal arrangements (e.g. methodologies used or parameter estimates data). The supervisor should strike an appropriate balance between the need for meaningful disclosure and the protection of proprietary and confidential information.

20.0.15 A consolidated group as determined under applicable accounting standards may differ from a group for the purposes of takāful or insurance supervision (see TCP 23: Group-Wide Supervision). In circumstances where this is the case, the supervisor may require disclosures based on the scope of the group for supervisory purposes. Where a TU's scope of the group is different under applicable accounting standards and solvency standards, it may be appropriate if reasons are provided and an explanation is given about the basis on which disclosures have been provided.

20.0.16 Disclosures by TUs may cross-reference existing public disclosures to avoid duplication.

20.1 Subject to their nature, scale and complexity, TOs make audited financial statements for TUs available at least annually.

20.1.1 Where audited financial statements are not required by the supervisor given the nature, scale and complexity of a TU (e.g. for a small local branch office of a foreign TU), the supervisor may require that similar information is made publicly available by other means.

20.2 TOs disclose, at least annually and in a way that is publicly accessible, appropriately detailed information on their:
- company profile;
- corporate governance framework;
- Shari‘ah governance framework;
- technical provisions;
- takāful risk exposure;
- financial instruments and other investments;
- investment risk exposure;
- asset–liability management;
- capital adequacy;
- liquidity risk; and
- financial performance.

20.2.1 In developing disclosure requirements, the supervisor may consider whether such disclosures are:
- easily accessible and up to date;
- comprehensive, reliable and meaningful;
• comparable between different TUs operating in the same market;
• consistent over time so as to enable relevant trends to be discerned; and
• aggregated or disaggregated so that useful information is not obscured.

20.2.2 Information should be disseminated in ways best designed to bring it to the attention of takāful participants and market players, but taking into account the relative effectiveness and costs of different methods of dissemination (e.g. printed versus digital methods).

20.2.3 Information should be provided with sufficient frequency and timeliness to give a meaningful picture of the TU to takāful participants and market players. The need for timeliness should be balanced against that for reliability.

20.2.4 Disclosure requirements may also have to balance the interests of reliability against those of relevance or usefulness. For example, in some long-tail classes of takāful, realistic projections as to the ultimate cost of incurred claims are highly relevant. However, due to uncertainties, such projections are subject to a high degree of inherent errors of estimation. Qualitative or quantitative information can be used to convey to users an understanding of the relevance and reliability of the information disclosed.

20.2.5 Information should be sufficiently comprehensive to enable takāful participants and market players to form a well-rounded view of a TU’s financial condition and performance, and its business activities, and the risks related to those activities. In order to achieve this, information should be:
• well-explained so that it is meaningful;
• complete so that it covers all material circumstances of a TU and, where relevant, those of the group of which it is a member; and
• both appropriately aggregated, so that a proper overall picture of the TU is presented, and sufficiently disaggregated so that the effect of distinct material items may be separately identified.

20.2.6 Information should, so far as practicable, reflect the economic substance of events and transactions as well as their legal form. The information should be neutral (i.e. be free from material error or bias) and complete in all material respects.

Company Profile

20.3 Disclosures include information about the TU’s company profile, such as:
• the nature of its business;
• its takāful operating model;
• its corporate structure;
• key business segments;
• the external environment in which it operates;
• the vision, mission and values that the firm follows in its operations; and
• its objectives, and its strategies for achieving those objectives.

20.3.1 The overall aim for the company profile disclosure is for TOs to provide a contextual framework for the other information required to be made public.

20.3.2 Disclosures on the nature of the TU’s business and its external environment should assist policyholders and market participants in assessing the strategies adopted by the TO for the TU.

20.3.3 Disclosures relating to the takāful operating model used, including a summary description, an explanation of the contracts used, the structure and (if applicable) segregation of funds within the TU and the nature of cash flows between them, help to provide an understanding of the way that the takāful business is operated, how the firm finances its activities, and the entitlements of takāful participants. Such an understanding assists informed interpretation of other information to be disclosed.

20.3.4 Disclosures may include information about the TU’s corporate structure, which should include any material changes that have taken place during the year. For insurance groups, where provided, such disclosures should focus on material aspects, both in terms of the legal entities within the corporate structure and the business functions undertaken within the group. In the event of differences in the composition of a group for supervisory purposes and for public reporting purposes, it would be useful if a description of the entities constituting those differences was also provided.

20.3.5 Disclosures may include information on the key business segments, and the main trends, factors and events that have contributed positively or negatively to the development, performance and position of the company.

20.3.6 Disclosures may include information on the TU’s competitive position and its business models (such as its approach to dealing with and settling claims, or to acquiring new business), as well as significant features of regulatory and legal issues affecting its business.

20.3.7 Disclosures may include information about company objectives, strategies and time frames for achieving those objectives, including the approach to risk appetite, methods used to manage risks, and key resources available. To enable takāful participants and market players to assess these objectives, and the TO’s ability to achieve them, it may be appropriate if the TO also explains significant changes in strategy compared to prior years.

20.3.8 Key resources available may include both financial and non-financial resources. For non-financial resources the TO may, for example, provide information about its human and intellectual capital.
Corporate Governance Framework

20.4 The supervisor requires that disclosures about the TO’s corporate governance framework for the TU provide information on the key features of the framework, including its internal controls and risk management, and how they are implemented.

20.4.1 Disclosures should include the manner in which key business activities and control functions are organised, and the mechanism used by the board to oversee these activities and functions, including for changes to key personnel and management committees. Such disclosures should demonstrate how the key activities and control functions fit into a TO’s overall risk management framework for the TU.

20.4.2 Disclosures should include information pertaining to the composition, responsibilities and remuneration of the Sharī`ah board.

20.4.3 Where the takāful business model involves segregation of funds (typically, between a shareholders’ fund, a participants’ risk fund and a participants’ investment fund, where applicable), disclosures should include a description of how segregation of funds is maintained, and how conflicts of interest are managed between the owners of different funds – in particular, those attributable to the TO and those attributable to takāful participants. In the case of a window, disclosures should also include a description of how funds attributable to the window are kept separate from those of the host conventional insurer.

20.4.4 Where a material activity or function of a TO is outsourced, in part or in whole, disclosures may include the TO’s outsourcing policy and how it maintains oversight of, and accountability for, the outsourced activity or function.

20.5 The supervisor requires that disclosures about the TU’s Sharī`ah governance framework provide information on the key features of the framework and its operation.

20.5.1 The supervisor should require TOs to provide information on their Sharī`ah governance framework, including the structure, systems, processes and controls employed by them for the purpose of ensuring Sharī`ah compliance in their entire takāful business activities.

20.5.2 The information provided according to the previous paragraph should include:
   a. a clear statement articulating the board’s responsibility and accountability for the Sharī`ah governance of the TU;
   b. the names and designations of the Sharī`ah board members;
   c. the qualifications and areas of expertise of each Sharī`ah board member;
   d. appointments and changes in Sharī`ah board membership;
e. the attendance of each Sharī`ah board member for meetings during the financial year;
f. the role of the Sharī`ah board in supervising the TU’s activities;
g. Sharī`ah board fatāwā, along with the basis supporting these fatāwā and the process by which the Sharī`ah board reached its decisions. These fatāwā should be made in accurate terms and in clear, simple, easy-to-understand language and form. Where a fatwā relates to a specific transaction, and cannot be disclosed without breaching commercial confidentiality, it may be appropriate to publish a brief summary;
h. any departures by the Sharī`ah board from its previous fatāwā, or revisions to those fatāwā, and the reasoning for such departure or revision;
i. the processes by which Sharī`ah decisions are sought and implemented;
j. the relationship between the Sharī`ah board and the centralised Sharī`ah committee, where one exists;
k. Sharī`ah non-compliance events leading to financial implications for the TU or its participants. Disclosure on this area must include the amount of Sharī`ah non-compliant income (if any), how Sharī`ah non-compliant earnings and expenditure occurred, and the associated rectification process related to the Sharī`ah non-compliant event;
l. Sharī`ah non-compliance events that did not result in financial implications to the TU or its participants (such as procedural lapses in following appropriate Sharī`ah processes), and how these were addressed, including control measures to avoid recurrence of such events; and
m. remuneration of Sharī`ah board members (either individually or in aggregate).

20.5.3 The supervisor should require TOs to disclose their annual Sharī`ah board reports, including a statement by Sharī`ah board members as to whether they have reviewed and approved the principles, policies, products and contracts relating to the transactions undertaken by and within the TU.

Investment Activity

20.5.4 In addition to the disclosures specified at 20.5.2(k) and (l) above, TOs should be required to disclose the following information for each fund:
- the adopted Sharī`ah screening methodology;
- any purification payments made in respect of assets or business which were not fully Sharī`ah-compliant; and
- the amount of any purification payments held by the TU and not yet paid.

Zakat

20.5.5 Where TOs take responsibility for zakat payments on behalf of either shareholders or takāful participants, they should be required to disclose:
- the method used in zakat calculation;
• the amount of zakat paid each year;
• the institutions or other persons that received the zakat payments; and
• the amount of zakat held by the TU and not yet paid.

20.5.6 If the TO does not pay zakat (e.g. because it is not required by the law or not authorised by shareholders or participants to do so), then sufficient information should be disclosed either publicly or on an individual basis to allow shareholders, other investors, and participants in investment-related takāful contracts to calculate their own zakat contributions.

Technical Provisions

20.6 The supervisor requires that disclosures about the TU’s technical provisions are presented by material takāful business segment and include, where relevant, information on:
• the future cash-flow assumptions;
• the rationale for the choice of discount rates;
• the risk adjustment methodology where used; and
• other information as appropriate to provide a description of the method used.

20.6.1 Disclosures related to technical provisions should provide information on how those technical provisions are determined. As such, disclosures may include information about the level of aggregation used and the amount, timing and uncertainty of future cash flows in respect of takāful obligations.

20.6.2 Where the operating model requires segregation of funds, disclosures under this standard are made in respect of each segregated fund, where those disclosures differ between funds.

20.6.3 Disclosures should include a presentation of technical provisions and retakāful and/or reinsurance assets on a gross basis. However, it may be useful to have information about technical provisions presented on both a net and gross basis.

20.6.4 Where, in a segregated fund model, expenses attributable to future claim settlement are borne in a different fund (e.g. where, under the terms of the contract, the takāful participants’ responsibility for expenses attributable to claims settlement are discharged by the payment of an upfront wakālah fee to the SHF which then bears the expense risk), the technical provisions include the provision made by the SHF for such future expenses. TCP 14: Valuation provides additional information on the valuation of technical provisions.

20.6.5 Information may be disclosed about the method used to derive the assumptions for calculating technical provisions (separately for each segregated fund, including the SHF where relevant), including the discount rate used. Disclosures may also include information about significant changes in assumptions and the rationale for the changes.
20.6.6 When applicable, information about the current estimate and margin over the current estimate may include the methods used to calculate them, whether or not these components of technical provisions are determined separately. If the methodology has changed since the last reporting period, it would be useful to include the reasons for the change and any material quantitative impact.

20.6.7 It may be useful if the TO provides an outline of any model(s) used and describe how any range of scenarios regarding future experience has been derived.

20.6.8 Disclosures may include a description of any method used to treat acquisition costs and whether future profits on existing business have been recognised.

20.6.9 Where surrender values are material, disclosures may include the TU's surrender values payable.

20.6.10 Disclosure of a reconciliation of technical provisions from the end of the previous year to the end of the current year may be particularly useful.

20.6.11 Disclosure of technical provisions may be presented in two parts:

- one part that covers claims from takāful events which have already taken place at the date of reporting (claims provisions including incurred but not reported [IBNR] and incurred but not enough reported [IBNER] provisions) and for which there is an actual or potential liability; and
- another part that covers losses from takāful events which will take place in the future (e.g. the sum of provision for unearned contributions and provision for unexpired risks; also termed “premium deficiency reserve”).

20.6.12 Providing this disclosure in two parts is particularly important for lines of takāful business where claims may take many years to settle.

*Family Takāful*

20.6.13 It may be useful if the disclosures include key information on the assumed rates, the method of deriving future mortality and disability rates, and whether customised tables are applied. Disclosures may include a family TO's significant assumptions about future changes of mortality and disability rates.

20.6.14 Disclosures may include the assumptions and methodologies employed to value significant options and other features, including the assumptions concerning takāful participant behaviour.

*General Takāful*
20.6.15 In order to enable takāful participants and market players to evaluate trends, disclosures for TUs may include historical data about earned premiums compared to technical provisions by class of business. To assess the appropriateness of assumptions and methodology used for determining technical provisions, historical data on the run-off result and claims development could be disclosed.

20.6.16 To facilitate the evaluation of a general TO’s ability to assess the size of the commitments to indemnify losses covered by the takāful contracts issued, disclosures for general TUs may include the run-off results over many years, to enable takāful participants and market players to evaluate long-term patterns (e.g. how well the TO estimates the technical provisions). The length of the time period should reflect how long-tailed the distribution of losses is for the takāful classes in question.

20.6.17 General TOs may disclose information for their TUs on the run-off results for incurred losses and for the provisions for future losses.

20.6.18 Disclosures for general TUs may include the run-off results as a ratio of the initial provisions for the losses in question. When discounting is used, disclosures should include the effect of discounting.

20.6.19 Except for short-tail business, the supervisor may require general TOs to disclose information for their TUs on the development of claims in a claims development triangle. A claims development triangle shows the TO’s estimate of the cost of claims (claims provisions and claims paid), as of the end of each year, and how this estimate develops over time. This information should be reported consistently on an accident-year or underwriting-year basis and be reconciled to amounts reported in the balance sheet.

Allocation of Surplus

20.6.20 Where the operating model provides for allocation (by distribution or otherwise) of underwriting surpluses to takāful participants, it may enhance takāful participant and market participant understanding if disclosures include information on the conditions for the amount and timing for allocation, and the extent, if any, to which amounts of surplus allocated to takāful participants are reflected in technical provisions, including in participants’ investment funds. Disclosures could also be required on the extent to which such allocation is contractual and/or discretionary.

20.6.21 Disclosures may include quantitative information on any maximum or minimum allocation, and actual distributions made – for example, identifying the quantum of amounts (if any) paid from participants’ investment accounts or takāful contributions waived that arise from allocation of underwriting surplus.

Takāful Risk Exposures
The supervisor requires that disclosures about the TU’s reasonably foreseeable and material takāful risk exposures, and their management, include information on:

- the nature, scale and complexity of risks arising from its takāful contracts;
- the TU’s risk management objectives and policies;
- models and techniques for managing takāful risks (including underwriting processes);
- its use of retakāful and/or reinsurance or other forms of risk mitigation; and
- its takāful risk concentrations.

Disclosure should be made separately for each segregated takāful risk fund of the TU, bearing in mind that where there are multiple such funds the risk profile may vary from one such fund to another.

Disclosures may include a quantitative analysis of the TU’s sensitivity to changes in key factors both on a gross basis and taking into account the effect of retakāful and other forms of risk mitigation on that sensitivity. For example, disclosures for TUs may include a sensitivity analysis by family TOs to the changes in mortality and disability assumptions or sensitivities to increased claim inflation by general TOs.

Where an insurance group includes legal entities in other sectors, disclosures may include the risk exposure of the TUs from those other entities and procedures in place to mitigate those risks.

Disclosures may include a description of the TU’s risk appetite and its policies for identifying, measuring, monitoring and controlling takāful risks, including information on the models and techniques used.

Disclosures may include information on the TU’s use of hedging mechanisms to hedge risks arising from takāful contracts. This information may include a summary of internal policies on the use of those mechanisms.

Disclosure of how a TU uses retakāful and other forms of risk mitigation may enable takāful participants and market participants to understand how the TU controls its exposure to takāful risks.

Disclosures may include quantitative data on the TU’s overall retakāful/reinsurance programme to explain the net risk retained and the types of retakāful/reinsurance arrangements made (treaty, facultative, proportional or non-proportional) as well as any risk mitigating devices that reduce the risks arising out of the retakāful/reinsurance cover and the Shari‘ah compliance status of those devices.

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60 See footnote 18.
20.7.7 Where the TU makes material use of conventional reinsurance rather than retakāful, it should explain for each line of business why this has been done.

20.7.8 It may be beneficial if disclosures detail separately the retakāful/reinsurers’ share of technical provisions and receivables from retakāful/reinsurers on settled claims. Further quantitative disclosures on reinsurance may include:
- the credit quality of the retakāful/reinsurers (e.g. by grouping retakāful/reinsurance assets by credit rating);
- credit risk concentration of retakāful/reinsurance assets;
- information on any arrangement to mitigate the risk that retakāful/reinsurers will be unable to meet claims against them for recovery when those claims fall due for payment to the TU;
- the development of retakāful/reinsurance assets over time; and
- the ageing of receivables from retakāful/reinsurers on settled claims.

20.7.9 It may be useful if disclosures include the impact and planned action when the expected level of scope of cover from a retakāful/risk mitigation contract is not obtained.

20.7.10 Description of the TU’s risk concentrations may include, at least, information on the geographical concentration of takāful risk, the economic sector concentration of takāful risk, the extent to which the risk is reduced by retakāful and other risk mitigating elements, and, if material, the risk concentration inherent in the retakāful cover.

20.7.11 Disclosures may include the geographical concentration of premiums. The geographical concentration may be based on where the covered risk is located, rather than where the business is written.

20.7.12 If material, disclosures may include the number of retakāful providers that it engages, as well as the highest concentration ratios. For example, it would be appropriate to expect a TO to disclose its highest contribution concentration ratios, which shows the contributions ceded to a TU’s largest retakāful providers as a ratio of the total retakāful ceded contribution.

Financial Instruments and Other Investments

20.8 The supervisor requires that disclosures about the TU’s financial instruments and other investments include information on:
- instruments and investments by class;
- investment management objectives, policies and processes; and
- values, assumptions and methods used for general purpose financial reporting and solvency purposes, as well as an explanation of any differences, where applicable.

20.8.1 Where segregation of funds is practised under the takāful business model adopted, these disclosures are made separately for each fund.
For the purposes of disclosure, a TO may group assets and liabilities with similar characteristics and/or risks into classes and then disclose information segregated by those classes.

Where investment management objectives, policies and processes differ between segments of a TU's investment portfolio (e.g. between funds), disclosures should be sufficient to provide an understanding of those differences.

When providing disclosures around the uncertainty of reported values of financial instruments and other investments, it may be helpful if the effect of hedging mechanisms on that uncertainty is also disclosed.

**Investment Risk Exposures**

The supervisor requires disclosures about the TU's material investment risk exposures and their management.

Disclosures may include quantitative information about the TU's exposure to:
- currency risk;
- market risk;
- credit risk; and
- concentration risk.

Where segregation of funds is practised, this information should be disclosed both in aggregate and on a fund-by-fund basis, since a correlation of risk among the different funds may affect the ability of the SHF to support the PRF if the crystallisation of this risk makes it necessary. It may also affect the ability of the PIF to make contributions to the PRF where this is part of the operating model.

The risks listed above may affect both assets and liabilities. For example, market risk arising from movements in rates of return may be reflected in changes in the valuation of a TU's fixed-income investments as well as changes in the valuation of takāful liabilities if they are discounted using market rates of return. Changes in rates of return may also change the amounts that a TU has to pay for its financing in the event it enters into a new financing arrangement. Therefore, required disclosure may include the risk exposure arising from both a TU’s assets and its liabilities.

Disclosures may include the investment return achieved together with the risk exposure and investment objective. Disclosure of risk exposures can provide takāful participants and market participants with valuable insight into both the level of variability in performance that one can expect when economic or market conditions change, and the ability of a TU to achieve its desired investment outcome.
For investment risk exposures, disclosures may include the intra-period high, median and low exposures where there have been significant changes in exposure since the last reporting date. Disclosures may also include the amount bought and sold during a reporting period as a proxy for turnover. Such disclosure of risk exposures may also be required for each asset class.

In jurisdictions that require investment disclosures to be grouped by risk exposure, the disclosures should provide information about the risk management techniques used to measure the economic effect of risk exposure. Such disclosure may include an analysis by type of asset class.

Disclosures may include information on the TU's use of hedging mechanisms to manage investment risks, including a summary of internal policies on the use of those mechanisms.

Disclosures may include information on whether or not the TO carries out stress tests or sensitivity analysis for the TU on its investment risk exposures (e.g. the change in capital resources as a percentage of total assets corresponding to a 100 basis point change in profit rates) and, if so, disclose the model, process and types of assumptions used and the manner in which the results are used as part of its investment risk management practices.

For securities other than shares, disclosures on the sensitivity of values to market variables may include breakdowns by credit rating of issue, type of issuer (e.g. government, corporate) and period to maturity.

In addition to breakdowns on ratings and types of credit issuers, the TO should disclose the aggregate credit risk arising from off-balance sheet exposures.

**Asset–Liability Management**

Disclosures about the TO's asset–liability management include information on:

- ALM in total, for each fund (where segregation of funds is practised), and, where appropriate, at a segmented level;
- the methodology used and the key assumptions employed in measuring assets and liabilities for ALM purposes; and
- any capital and/or provisions held as a consequence of a mismatch between assets and liabilities.

To provide information on its ALM approach, disclosures may include qualitative information explaining how the TO manages assets and liabilities in a coordinated manner. (Where segregation of funds is practised, this should be at the level of each fund, including the SHF.) The explanation could take into account the ability to realise its investments quickly, if necessary, without substantial loss, and sensitivities to
fluctuations in key market variables (including rates of return, exchange rate, and equity price indices) and credit risks.

20.10.2 Where a TU’s ALM is segmented (e.g. by different lines of business), disclosures may include information on ALM at a segmented level. Where segregation of funds is practised, this segmentation may take place within a segregated fund, in which case disclosure may include information on such segmentation within the disclosed fund-level information.

20.10.3 Where hedging instruments\(^\text{61}\) are used, it may be useful if the disclosures include a description of both the nature and effect of their use.

20.10.4 Disclosures may include the TU’s sensitivity of regulatory capital resources and provisions for mismatching to:
- changes in the value of assets; and
- changes in the discount rate or rates used to calculate the value of the liabilities.

**Capital Adequacy**

20.11 Disclosures about the TU’s capital adequacy include information both overall and, where segregation of funds is practised, at the level of each fund, including the SHF, on:
- its objectives, policies and processes for managing capital and assessing capital adequacy;
- the solvency requirements of the jurisdiction(s) in which the TU operates; and
- the capital available to cover regulatory capital requirements. If the TO uses an internal model to determine capital resources and requirements, information about the model is disclosed.

20.11.1 Information about objectives, policies and processes for managing capital adequacy assists in promoting the understanding of risks and measures which influence the capital calculation and the risk appetite that is applied.

20.11.2 It may be useful if the TO discloses information to allow market participants to assess the quantity and quality of its capital in relation to regulatory capital requirements.

20.11.3 Disclosures may include qualitative information about its management of capital regarding:
- instruments regarded as available capital;
- key risks and measures which influence the capital calculation; and
- the TU’s risk appetite.

\(^\text{61}\) See footnote 18.
Where segregation of funds is practised, disclosures may include qualitative and quantitative information on mechanisms for capital support between funds, such as *qard* advanced or pledged, showing the impact on the capital adequacy of the recipient fund as well as on that of the providing fund (normally, the SHF).

It may be useful if the disclosures include a description of any variation in the group as defined for capital adequacy purposes from the composition of the group used for general purpose financial reporting purposes.

**Liquidity Risk**

The supervisor requires that disclosures about the TU's liquidity risk include sufficient quantitative and qualitative information to allow a meaningful assessment by market participants of the TU's material liquidity risk exposures.

Disclosures on liquidity risk should include:
- quantitative information on the TU's sources and uses of liquidity, considering liquidity characteristics of both assets and liabilities; and
- qualitative information on the TU's liquidity risk exposures, management strategies, policies and processes.

Disclosures should discuss known trends, significant commitments and significant demands. Disclosures should also discuss reasonably foreseeable events that could result in the TU's liquidity position improving or deteriorating in a material way.

Where segregation of funds is practised, disclosures as to liquidity risk are made also at the level of each fund. Disclosures include qualitative and quantitative information on mechanisms for liquidity support between funds, such as *qard* advanced or pledged, showing the impact on the liquidity position and risk of the donor and recipient funds.

**Financial Performance**

Disclosures about the TU’s financial performance, in total and at a segmented level, include information on:
- earnings analysis;
- claims statistics, including claims development;
- pricing adequacy; and
- investment performance.

**General Financial Performance**

Disclosures should help *takāful* participants and market players better understand how profit emerges over time from new and in-force *takāful* contracts.
Where segregation of funds is practised, disclosures as to financial performance are made also at the level of each fund. Disclosures include qualitative and quantitative information on the relationship between funds.

Disclosure may include a statement of changes in equity showing gains and losses recognised directly in equity, as well as capital transactions with, and distributions to, shareholders, and any distribution of surplus from segregated funds, whether to takāful participants or otherwise.

Disclosures may include information on its operating segments and how they were determined.

An operating segment is a component of an entity that engages in business activities from which it may earn revenues and incur expenses and whose operating results are regularly reviewed by the entity's management to make decisions about resources to be allocated. Examples of features by which business is segmented are:

- type of business: family takāful, general takāful, investment management; and
- mix of organisational and geographic approach: e.g. takāful jurisdiction X, takāful jurisdiction Y, takāful (other), asset management jurisdiction Z.

Disclosures may include the impact of amortisation and impairment of intangible assets on financial performance.

Relationships between Segregated Funds and Other Funds

Disclosures include information on any transfers between funds, and the sources of income to the SHF, including, where applicable, wakālah fees and mudarib's share, and any commission or other reward obtained by the SHF from third parties.

Disclosures include information on how income and expenses are allocated between funds, including criteria for sharing any common income or expenses between funds, such as expenses of depreciation or amortisation (e.g. of direct and indirect acquisition expenses).

Technical Performance

The TO may provide statements of profit and loss that include the results, both gross and net of retakāful, of their underwriting by broad lines of business.

If the TU is a ceding TU, disclosures may include gains and losses recognised in profit or loss from ceding retakāful/reinsurance, including any surplus distributions from RTUs.

Technical Performance for General TOs
In order to judge how well 
\textit{takāful} contributions cover the underlying risk of the 
\textit{takāful} contracts and the administration expenses (pricing adequacy), disclosures may include data on:
\begin{itemize}
  \item loss ratio;
  \item expense ratio;
  \item combined ratio; and
  \item operating ratio.
\end{itemize}

These ratios should be calculated from the profit and loss account of the reporting year and be gross of \textit{retakāful} in order to neutralise the effect of mitigation tools on the technical performance of the direct business. Gains on \textit{retakāful} cannot be expected to continue indefinitely without price adjustments from \textit{retakāful}. If the net ratios are materially different from the gross ratios, then both ratios should be disclosed. The ratios should be measured either on an accident-year or an underwriting-year basis.

When discounting is used, disclosures may include information on the discount rates used and method of discounting to be disclosed. The discount rates should be disclosed at an appropriate level of aggregation by duration – for example, for each of the next five years and the average rate for claims expected to be paid after five years.

Such disclosure should be accompanied by supporting narrative, covering an appropriate period, to enable \textit{takāful} participants and market players to better evaluate long-term trends. Information relating to previous years should not be recalculated to take into account present information. The length of the period may reflect the historical volatility of the particular class of \textit{takāful} business.

It may be appropriate in the case of high-volume, homogeneous classes for the supervisor to require TOs to disclose statistical information on claims. For instance, the TO could describe the trend in the number of claims and the average size of claims. To be relevant, this information should be linked to the level of business (e.g. number of contracts or earned contributions).

In principle, the trend in claims may reflect the development in \textit{takāful} risks. As it is difficult to point to one good measurement method of \textit{takāful} risk, several can be considered. However, it would be normal for general TOs to be required to disclose historical data for TUs accompanied by supporting narrative at least on:
\begin{itemize}
  \item the mean cost of claims incurred (i.e. the ratio of the total cost of claims incurred to the number of claims) in the accounting period by class of business; and
  \item claims frequency (e.g. the ratio of the number of claims incurred in the reporting period to the average number of \textit{takāful} contracts in existence during the period).
\end{itemize}

\textit{Source of Earnings Analysis for Family TUs}
Where an applicable jurisdictional standard does not require a similar analysis to be disclosed, it may be useful for disclosures to include expected earnings on in-force business. This represents the earnings on the in-force business that were expected to be realised during the reporting period. Examples of this include expected release of risk margins, net management fees, and earnings on deposits.

Family TOs may disclose the impact of new business. This represents the impact on net income of the TU of writing new business during the reporting period. This is the difference between the takāful contribution received and the sum of the expenses incurred as a result of the agreement of the contract and the new technical provisions established when the contract is agreed. It is also affected by any methodology used to defer and amortise acquisition expenses.

It may be useful for family TOs to disclose experience gains and losses for the TU. This represents gains and losses that are due to differences between the actual experience during the reporting period and the technical provisions at the start of the year, based on the assumptions at that date.

Family TOs may disclose the impact on the TU's earnings of management actions and changes in assumptions.

Investment Performance

Investment performance is one of the key determinants of a TU's profitability. For many family contracts, returns that takāful participants receive are influenced either directly or indirectly by the performance of a TU's investments. Disclosure of investment performance is, therefore, essential to takāful participants and market players.

Disclosure of investment performance may be made on appropriate subsets of a TU's assets (e.g. assets belonging to the TU's family takāful business, assets belonging to statutory or notionally segregated portfolios, assets backing a group of investment-linked contracts, or assets grouped as the same asset class).

For investment performance disclosure related to shares, securities other than shares, and properties, the disclosures may include a breakdown of income (e.g. dividend receipts, other investment income, rental income), realised gains/losses, unrealised gains/losses, impairments and investment expenses.

Non-GAAP Financial Measures

TOs that publicly disclose non-GAAP financial measures for TUs are required to adhere to the specified practices regarding those measures, where applicable.
In many jurisdictions, publicly listed companies are expected to adhere to specific practices for disclosure of non-GAAP financial measures which have been promulgated by the domestic securities supervisor. The supervisor could consider standards promulgated by the domestic securities supervisor appropriate. However, the supervisor should consider whether any such requirements require modification or addition in order to be appropriate or adequate for takāful of the types carried on by TOs in its jurisdiction.

In the event that the supervisor considers that the practices for disclosure of non-GAAP financial measures, as promulgated by the domestic securities supervisor, require modification or addition in order to be appropriate or adequate for TUs, the supervisor engages in dialogue with the domestic securities supervisor with a view to achieving suitable modification of or addition to the requirements for TUs.

If no such requirements exist from the domestic securities supervisor for non-GAAP financial measures, the supervisor may promulgate requirements for TOs based on considerations of best practices and existing international guidance from key standard-setting bodies dealing with financial disclosures.

TCP 21: COUNTERING FRAUD IN TAKĀFUL

The supervisor requires that TOs and intermediaries take effective measures to deter, prevent, report and remedy fraud in takāful.

Introductory Guidance

Fraud in takāful (including retakāful) is a deceptive act or omission intended to gain advantage for a party committing the fraud (the fraudster) or for other parties. Most jurisdictions have legal provisions against fraud in takāful. In many jurisdictions, instances of fraud are criminal acts.

Fraud in takāful can take many forms and be perpetrated by any party involved in takāful, including TOs, TOs’ managers and staff, intermediaries, accountants, auditors, consultants, claims adjusters, third-party claimants and takāful participants. Where segregation of funds is practised, it is also necessary to consider the possibility of fraud to the benefit of one fund at the expense of another, with indirect impact on different stakeholders and decisions that they may make.

Fraud poses a serious risk to all financial sectors; fraud in takāful results in reputational as well as financial damage and social and economic costs. In the takāful sector, both TOs and takāful participants bear the costs. Losses caused by fraudulent activities affect TUs’ profits and potentially their financial soundness. To compensate, TUs raise contributions and this results in higher costs for takāful participants. Fraud may also result in the takāful participant discovering that they are not protected for risks they believed were covered, which can have a material impact on both...
customers and businesses. For these reasons, fraud may reduce consumer and shareholder confidence. It can affect the reputation of individual TUs, insurance groups and the takāful sector, and, potentially, economic stability more broadly.

21.0.4 Fraud may arise from, give rise to or be associated with instances of Shari'ah non-compliance, and any form of fraud is itself likely to detract from the TO’s claim to be Shari’ah-compliant. The discovery of fraud may affect public confidence in the Shari’ah compliance of the TU, of any group of which it is a part and the takāful market as a whole, potentially causing some takāful participants to cancel or not to renew their contracts.

21.0.5 Countering fraud is, in principle, the concern of the individual TOs and intermediaries. TOs and intermediaries need to understand and take steps to minimise their vulnerability to fraud.

21.0.6 Responsibility for ensuring that TOs and intermediaries have adequate fraud risk management ultimately lies with the board and senior management of the TO or intermediary.

21.0.7 The supervisor is one of the competent authorities that has an important role to play in countering fraud in takāful in its jurisdiction. There may be jurisdictions where several authorities have a responsibility for deterring, preventing, detecting, reporting and remedying fraud in takāful.

21.0.8 Fraud in takāful is an issue for supervisors if the risk of fraud is not addressed adequately. Therefore, supervisors should pay appropriate attention as to whether TOs and intermediaries have adequate and effective policies, procedures and controls in place to deter, prevent, detect, report and remedy fraud (see IAIS Application Paper on Deterring, Preventing, Detecting, Reporting and Remediying Fraud in Insurance).

21.0.9 The increasing integration of financial markets and the growing number of internationally active TUs and intermediaries make fraud and its potential global implications an important issue to address at the international level. Therefore, it is important that supervisors communicate with one another in addressing fraud across jurisdictions.

21.0.10 The supervisor should consider the application of these standards, particularly for intermediaries, taking into account that there are various business models ranging from sole traders to large enterprises.

21.1 Fraud in takāful is addressed by legislation which prescribes adequate sanctions for committing such fraud and for prejudicing an investigation into fraud.

21.1.1 Legislation should contain offences and sanctions for committing fraud and for prejudicing an investigation into fraud. It should also provide the ability to:
obtain documents and information, together with statements made by relevant individuals, for intelligence and investigation purposes, for disclosure to appropriate authorities;

- restrain assets which represent, or are believed to represent, the proceeds of fraud; and

- confiscate assets which are, or are believed to be, the proceeds of fraud.

21.1.2 Where segregation of funds is practised, legislation relating to fraud covers also fraudulent misallocation of revenues or expenses between funds.

21.1.3 It may be helpful for anti-fraud legislation to provide appropriate civil and criminal immunity for fraud reporting in good faith, including where no fraud was subsequently found to have occurred.

21.2 The supervisor has a thorough and comprehensive understanding of the types of fraud risk to which TUs and intermediaries are exposed. The supervisor regularly assesses the potential fraud risks to the takāful sector and requires TOs and intermediaries to take effective measures to address those risks.

21.2.1 The supervisor should identify the main vulnerabilities in its jurisdiction, taking into account independent risk assessments where relevant, and address them accordingly. These are not static assessments. They will change over time, depending on how circumstances develop and how threats evolve.

21.2.2 The supervisor should have a thorough and comprehensive understanding of:

- the activities undertaken and products and services offered by TOs and intermediaries; and

- internal, takāful participant, claims and intermediary fraud.

21.2.3 The supervisor should also consider whether fraud risks increase the risk of Shari‘ah non-compliance. While a supervisor may have no responsibility for enforcement of Shari‘ah compliance, Shari‘ah compliance is a prudential and conduct issue. The supervisor considers whether a TO’s Shari‘ah governance function adequately addresses the impact of fraud risk on Shari‘ah compliance – for example, where the fraud renders associated income of the TU, even if it does not have to be made over to another person to remedy the fraud or be forfeited under relevant laws, tainted in the hands of the TU and liable to purification.

21.2.4 The supervisor should consider the potential fraud risks alongside other risk assessments (including governance and market conduct) arising from its wider duties and be aware of the relevance of fraud to the duties it carries out in respect of other TCPs and standards.

21.3 The supervisor has an effective supervisory framework to monitor and enforce compliance by TOs and intermediaries with the requirements to counter fraud in takāful.
21.3.1 The supervisor should issue anti-fraud requirements by way of regulations, instructions or other documents or mechanisms that set out enforceable requirements with sanctions for non-compliance with the requirements.

21.3.2 The supervisor should issue guidance to TOs and intermediaries that will assist them to counter fraud effectively and to meet the requirements set by the supervisor.

21.3.3 The supervisor should have sufficient financial, human and technical resources to counter fraud, including the resources needed to be able to issue and enforce sanctions in relation to complex cases where TOs or intermediaries oppose such sanctions.

21.3.4 The staff of the supervisor engaging in anti-fraud activity should be appropriately skilled and provided with adequate and relevant training on countering fraud. Examples of issues to be covered under adequate and relevant training for the staff of the supervisor include fraud legislation (including offences), fraud typologies, techniques to be used by supervisors to ensure that TOs and intermediaries are complying with their obligations, and the issue and enforcement of sanctions. Similarly, TOs and intermediaries should provide relevant training on anti-fraud measures to board members, senior management and other staff as appropriate.

21.3.5 TOs (and, where relevant, intermediaries) should ensure that training in fraud awareness is extended to those responsible for the Shari‘ah governance function, and that those engaged in Shari‘ah governance are, where appropriate, included in fraud reporting protocols. TOs should also ensure that the Shari‘ah governance function is consulted in the event of fraud to determine the implications for Shari‘ah compliance, where such consultation is consistent with the TO’s obligations under other relevant laws.

21.3.6 The supervisor should take account of the risk of fraud at each stage of the supervisory process, where relevant, including the licensing stage.

21.3.7 The supervisor should assess whether TOs and intermediaries have adequate fraud risk management systems in place which are reviewed regularly. TOs and intermediaries should be able to demonstrate to the supervisor that they have effective management of their fraud risk and possible risks to their solvency or continuity caused by fraud. The supervisor should at least assess whether TOs and intermediaries:

- have effective policies, procedures and controls in place to deter, prevent, detect, report and remedy fraud;
- have an independent internal audit function and periodically carry out fraud-sensitive audits; and
- have allocated appropriate resources to deter, prevent, detect, record and, as required, promptly report fraud to the relevant authorities.
21.3.8 The supervisor should use both off-site monitoring and on-site inspections to:

- evaluate the effectiveness of the internal control system of TOs and intermediaries to manage fraud risks; and
- recommend or require appropriate remedial action where the internal control system is weak and monitor the implementation of such remedial actions.

21.3.9 As particular fraud risks arise from claims, the supervisor should cover claims management processes in its supervision. This may include reviewing and assessing claims data, the quality of client acceptances, and claims-handling processes. Regarding the risks of fraud occurring in the underwriting process, the supervisor should review relevant processes and controls – in particular, those concerned with verification of customer information.

21.3.10 The supervisor should have the power to take appropriate corrective and remedial action where TOs and intermediaries do not implement anti-fraud requirements effectively or in cases of fraud committed by the TO or intermediary. Depending on the severity of the situation and level of supervisory powers, this could include letters to management, directions, fines, the suspension of business, the appointment of alternative management and redress to customers.

21.3.11 Where a supervisor identifies suspected criminal activities in a TO or intermediary, it should ensure that relevant information is provided to the financial intelligence unit (FIU) and appropriate law enforcement agency and any other relevant supervisors.

21.4 The supervisor regularly reviews the effectiveness of the measures TOs and intermediaries and the supervisor itself are taking to deter, prevent, detect, report and remedy fraud. The supervisor takes any necessary action to improve effectiveness.

21.4.1 The review of effectiveness should take risk into account and assess whether established regulations and supervisory practices are being enforced.

21.4.2 The supervisor considers also the apparent effectiveness of the Sharī‘ah governance function in considering implications for Sharī‘ah compliance when fraud is detected and for any necessary remediation actions (such as purification of income tainted by association with fraud).

21.4.3 This review could cover aspects such as:

- the risks of fraud in the takāful sector and whether these are adequately addressed by the risk-based approach of the supervisor;
- the adequacy of the supervisor’s resources and training;
- whether the number and content of on-site inspections relating to anti-fraud measures are adequate;
- whether off-site supervision of anti-fraud measures is adequate;
• the findings of on-site inspections, including the effectiveness of training and implementation by TOs and intermediaries of anti-fraud measures;
• action taken by the supervisor against TOs and intermediaries;
• input from other authorities with anti-fraud responsibilities, such as information on fraud prosecutions and convictions;
• the number and nature of requests for information from other authorities concerning anti-fraud matters; and
• the adequacy of the requirements, guidance and other information provided by the supervisor to the sector which may vary on the basis of the business undertaken.

Such reviews should enable the supervisor to identify any necessary actions which need to be taken to improve effectiveness.

21.4.4 The supervisor should consider contributing to or promoting anti-fraud initiatives such as:
• working with relevant industry and trade associations to encourage and maintain an industry-wide approach to deterring, preventing, detecting, reporting and remedying fraud;
• the establishment of anti-fraud committees consisting of industry or trade organisations, law enforcement agencies, other supervisors, other authorities and possibly consumer organisations as a platform to address fraud in takāful – for example, by discussing trends, risks, policy issues, profiles and modus operandi;
• the establishment of a fraud database on suspected and/or confirmed fraud attempts; TOs could be requested or required to submit information and statistics with respect to these attempts;
• the exchange of information between TOs and intermediaries on fraud and fraudsters, including, as appropriate, through the use of databases to the extent permitted by local legislation;
• the enhancement of consumer/takāful participant awareness concerning the existence, nature and effects of takāful fraud, through effective education and media campaigns; and
• cooperation between organisations involved with combating fraud in the takāful sector, such as organisations for accountants, forensic auditors and claims adjustors.

21.4.5 Whenever a supervisor is informed of substantiated suspicious fraudulent activities which may affect TUs, intermediaries or the takāful industry as a whole, it should consider whether to convey warning information to TOs and intermediaries to the extent permitted by local legislation.

21.4.6 The supervisor should maintain records on the number of on-site inspections relating to the combating of fraud measures and on sanctions it has issued to TOs and intermediaries with regard to inadequate anti-fraud measures.

21.5 The supervisor has effective mechanisms in place, which enable it to cooperate, coordinate and exchange information with other competent
authorities, such as law enforcement authorities, as well as other supervisors concerning the development and implementation of policies and activities to deter, prevent, detect, report and remedy fraud in takāful.

21.5.1 Mechanisms of cooperation and coordination should normally address:
• operational cooperation and, where appropriate, coordination between supervisors and other anti-fraud competent authorities; and
• policy cooperation and, where appropriate, coordination across all relevant anti-fraud competent authorities.

21.5.2 Where the supervisor identifies suspected fraud in TUs or intermediaries, it should ensure that relevant information is provided to the FIU and appropriate law enforcement agency and any other relevant supervisors.

21.5.3 The supervisor should take all necessary steps to cooperate and exchange information with other relevant authorities. There should be contact by the supervisor with the FIU and appropriate law enforcement agency to ascertain any concerns it has and any concerns expressed by TOs and intermediaries and to obtain feedback on trends in reported cases.

21.5.4 The supervisor should consider appointing within its office a contact for anti-fraud issues and for liaising with other competent authorities to promote an efficient exchange of information.

21.5.5 The supervisor should maintain records on the number and nature of formal requests for assistance made by or received from supervisors or law enforcement agencies concerning fraud or potential fraud, including whether the request was granted or refused.

TCP 22: ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM

The supervisor requires TOs and intermediaries to take effective measures to combat money laundering and terrorist financing. The supervisor takes effective measures to combat money laundering and terrorist financing.

Introductory Guidance

22.0.1 The takāful sector is potentially at risk of being misused for money laundering and terrorist financing. This exposes the sector to legal, operational and reputational risks.

22.0.2 Money laundering (ML) is the processing of criminal proceeds to disguise their illegal origin. When criminal activity generates substantial profits, the individual or group involved must find a way to control and “legitimise” funds without attracting attention to the underlying activity or the persons involved. Criminals do this by disguising the sources, changing the form, or moving the funds to a place where they are less likely to attract attention, and therefore may use the financial sector, including the takāful sector, to
do so. Examples of criminal activity which may generate large profits and lead to money laundering include embezzlement, tax evasion, insider trading, bribery, cyber-crimes, illegal arms sales, smuggling, drug trafficking, prostitution, human trafficking, as well as corruption and organised crime.

22.0.3 Terrorist financing (TF) is the financing of terrorist acts, and of terrorists and terrorist organisations. It refers to the wilful provision or collection of funds by any means, directly or indirectly, with the unlawful intention that they should be used, or in the knowledge that they are to be used, in full or in part to carry out a terrorist act by a terrorist organisation or by an individual terrorist, or to support terrorists or terrorist organisations. Terrorist financing offences may constitute predicate offences for the crime of money laundering, in accordance with applicable law.

22.0.4 In addition to legal provisions on ML and TF applicable to all financial services entities, ML and TF activities also threaten the ethical basis, based on Sharī`ah, in accordance with which takāful business is stated to operate. In addition, if otherwise legitimate income is found to be tainted due to connection with illegal origins or terrorism, that income may require purification, reducing the funds available to provide takāful entitlements.

22.0.5 The Financial Action Task Force (FATF) is an inter-governmental body, established to set international standards for anti-money laundering and combating the financing of terrorism. The FATF standards are comprised of its individual recommendations together with interpretive notes and the applicable definitions in the FATF glossary. In this TCP, the term “FATF Recommendations” encompasses all of these components of the FATF standards. The FATF Recommendations are directed at jurisdictions, and supervisors should therefore reference their own national risk assessment, applicable laws and regulations with respect to AML/CFT.

22.0.6 This TCP is intended to be consistent with the FATF Recommendations. However, compliance with the FATF Recommendations does not necessarily imply observance of TCP 22, nor does observance of TCP 22 necessarily imply compliance with the FATF Recommendations.

22.0.7 According to the FATF:62

- the ML/TF risks associated with the life insurance sector are generally lower than those associated with other financial products (such as loans or payment services) or other sectors (such as banking); and
- many life insurance products are not sufficiently flexible to be the first vehicle of choice for money launderers.

62 View expressed in the FATF Guidance (see paragraph 22.0.12). FATF does not draw a distinction between conventional insurance and takāful in this respect.
However, as with other financial products, there is a risk that the funds used to purchase family *takāful* may be the proceeds of crime.

22.0.8 This TCP applies to the underwriting and placement of family *takāful* and other investment-related *takāful*. Depending upon the jurisdiction’s assessment of the ML/TF risk posed by the general *takāful* sector, the jurisdiction should consider whether and to what extent to apply this TCP to that sector as well.

22.0.9 The FATF Recommendations require jurisdictions to designate a “competent authority” or authorities to have responsibility for ensuring that financial institutions (including TOs, TUs and intermediaries) adequately comply with the jurisdiction’s approach to implementing the FATF Recommendations to combat ML/TF. The AML/CFT competent authority is often designated by a jurisdiction’s legislation. There may be jurisdictions where several authorities have AML/CFT responsibilities for the *takāful* sector. Competent authorities may include supervisors, law enforcement agencies and a financial intelligence unit (FIU) which serves as a jurisdictional centre for receiving and analysing information (such as suspicious transaction reports) and disseminating information regarding potential ML/TF.

22.0.10 In some jurisdictions, the supervisor may not be designated as an AML/CFT competent authority, but nevertheless all supervisors must understand the risk of ML/TF to the *takāful* sector and take steps to help combat such risk.

22.0.11 The standards and guidance related to TCP 22 are divided into two parts. Part A applies where the supervisor is a designated AML/CFT competent authority, or acts on behalf of such designated competent authority. Part B applies where the supervisor is not a designated AML/CFT competent authority. To demonstrate observance of this TCP the supervisor must meet the requirements of the standards in either Part A or Part B, or both, according to the circumstances of its jurisdiction.

22.0.12 In implementing this TCP, the supervisor may consider as relevant various guidance available from the FATF, including its “Risk-Based Approach Guidance for the Life Insurance Sector” (FATF Guidance). The FATF Guidance, which is non-binding, aims to support the design and implementation of a Risk-Based Approach (RBA) to AML/CFT for the conventional life insurance sector, taking into account applicable ML/TF risk assessments and legal and regulatory frameworks to combat money laundering and terrorist financing. The RBA concept is related to, but distinct from, the overarching concept of risk-based supervision that applies to all TCPs.

22.0.13 The RBA to AML/CFT is relevant to both the conventional life insurance sector and the family *takāful* sector (although some references to, for example, guaranteed investment entitlements or returns may not be applicable to family *takāful*).
22.0.14 As described in the TCP Introduction, this TCP applies to the supervision of TUs and, unless otherwise specified, to insurance groups. The supervisor may also consider FATF Guidance concerning supervision and mitigation of ML/TF risks at the group-wide level.

22.0.15 Certain FATF Recommendations require that supervision be applied to the implementation of targeted financial sanctions (TFS) related to terrorism, terrorist financing and financing of proliferation of weapons of mass destruction. Adherence to TFS is not subject to the RBA described in this TCP and TFS is not further addressed in this TCP. Whether takāful supervisors have responsibilities for TFS will depend upon the particular jurisdictional arrangements in place.

Part A: Where the Supervisor is a Designated AML/CFT Competent Authority

22.1 The supervisor:
- has a thorough and comprehensive understanding of the ML/TF risks to which TUs and/or intermediaries are exposed;
- uses available information to assess the ML/TF risks to the takāful sector in its jurisdiction on a regular basis; and
- applies an RBA consistent with the FATF Recommendations.

22.1.1 Consistent with the FATF Recommendations, RBA refers to:
- the general process by which a supervisor, according to its identification, understanding and assessment of risks, allocates its resources to AML/CFT supervision; and
- the specific process of supervising institutions (i.e. TOs, TUs and intermediaries, as applicable) that apply an AML/CFT RBA.

Understanding ML/TF Risks

22.1.2 The supervisor should have a thorough and comprehensive understanding of the ML/TF risks to which TUs and intermediaries are exposed arising from the activities undertaken and products and services offered by TOs and intermediaries.

22.1.3 In the context of ML/TF, “risk” encompasses threats, vulnerabilities, and consequences in relation to products (including services and transactions), geography, customers and delivery channels.

22.1.4 Some of the examples of attributes included below can be expected over the course of a long-term takāful contract and are not necessarily inherently suspicious; rather, they should be viewed as factors to consider with respect to AML/CFT RBA.

22.1.5 “Product-related risk” refers to the vulnerability of a product to ML/TF based on its design. The following are examples of product attributes which may tend to increase the ML/TF risk profile:
• acceptance of very high value or unlimited value payments or large volumes of lower value payments;
• acceptance of non-traceable payments such as cash, money orders, cashier cheques or virtual assets;
• acceptance of frequent payments outside a normal premium or payment schedule;
• allowance of withdrawals at any time or early surrender, with limited charges or fees;
• products that allow for high cash values;
• products that accept high-amount lump sum payments, coupled with liquidity features;
• products with provisions that allow a takāful contract to be cancelled within a stipulated time frame and the premiums paid to be refunded; and
• products that allow for assignment without the TO being aware that the beneficiary of the contract has been changed until such time as a claim is made.

22.1.6 Product-related risk also encompasses the vulnerability of a product to use by a third party or to unintended use based on the methods of transactions available (i.e. service- and transaction-related risk). The following are examples of service and transaction attributes which may tend to increase the ML/TF risk profile:

- Products have features or services which make it possible for customers to use the product in a way that is inconsistent with its purpose (e.g. a takāful contract intended to provide a long-term investment opportunity but which allows frequent or low-fee deposit/withdrawal transactions).
- The customer is not the payer or recipient of the funds.
- Products have features that allow loans to be taken against the takāful contract (particularly if frequent loans can be taken and/or repaid with cash).
- The product is allowed to be used as collateral for a loan and/or is written in a discretionary or other increased risk trust.
- The payment source or recipient of funds is outside of the jurisdiction (e.g. TO is in jurisdiction A and payment source is in jurisdiction B).
- There is a significant, unexpected or unexplained change in the customer’s pattern of payment, withdrawal or surrender.

22.1.7 “Geographic-related risk” refers to the risk that a market’s or customer’s geographic location or connections will enhance vulnerability to ML/TF. The following are examples of geographic attributes which may tend to increase the ML/TF risk profile:

- Jurisdictions are identified by credible sources as having weak governance, law enforcement and regulatory regimes, including jurisdictions identified by FATF statements as having weak AML/CFT regimes.
- Jurisdictions are identified by credible sources as having significant levels of organised crime, corruption or other criminal activity,
including source or transit countries for illegal drugs, human trafficking, smuggling and illegal gambling.

- Jurisdictions are subject to sanctions, embargoes or similar measures issued by international organisations (such as the United Nations).

22.1.8 “Customer-related risk” refers to the risk that the TO is doing business with a customer who is not adequately identified or may be involved with ML/TF. Customer-related risk factors include: customer identity; third-party involvement; customer source of wealth and funds; politically exposed customers; and known criminals or terrorists. The following are examples of customer attributes which may tend to increase the ML/TF risk profile:

- The structure of a legal entity that is a customer, takāful participant or beneficiary obscures, or makes it difficult to identify, the ultimate beneficial owner or controlling interests.
- The customer is reluctant to provide identification; exhibits difficulty producing identification; or provides identification documents of questionable authenticity.
- A gatekeeper, or a third party apparently unrelated to the customer, is involved.
- The business or occupation of the customer is high in risk (e.g. it is cash-intensive).
- There is a mismatch between the wealth and the income of the customer and the proposed premium amounts, deposit amounts or policy limits.
- The customer is associated with negative news which may affiliate them with allegations of criminal behaviour, or has ties to or is on a designated sanctions list.
- The customer is considered a politically exposed person.

22.1.9 “Delivery channel” refers to the method offered to or used by a customer to start a new policy or account. “Delivery channel-related risk” refers to the vulnerability of the delivery channel to ML/TF based on attributes that may make it easier to obscure customer identity or the source of funds. The following are examples of delivery channel attributes which may tend to increase the ML/TF risk profile:

- Sales are not face-to-face, or are without adequate safeguards for confirmation of identification or to mitigate the risks of identity fraud.
- Payments are via an intermediary that may obscure the source of payment (e.g. if there is a long chain of intermediaries).

Assessing ML/TF Risks

22.1.10 The supervisor should assess the main ML/TF risks to the takāful sector in its jurisdiction. Such risk assessments may provide for recommendations on the allocation of responsibilities and resources at the jurisdictional level based on a comprehensive and up-to-date understanding of the risks. These assessments will change over time, depending on how circumstances develop and how risks evolve. For this
reason, risk assessments should be undertaken on a regular basis and be kept up to date.

22.1.11 The supervisor should consider the potential ML/TF risks alongside other risk assessments (e.g. governance and market conduct) arising from its wider duties.

22.1.12 When a jurisdiction-wide risk assessment has been conducted (e.g. during a National Risk Assessment [NRA] process as contemplated in the FATF Recommendations, if applicable), the supervisor should have access to the results and take them into account. The supervisor should participate in such an assessment to inform the assessment and to improve the supervisor's understanding of the risks.

22.2 The supervisor:

- issues to TOs and/or intermediaries enforceable means on AML/CFT obligations consistent with the FATF Recommendations, for matters which are not in primary legislation;
- establishes guidance that will assist TOs and/or intermediaries to implement and comply with their respective AML/CFT requirements; and
- provides TOs and/or intermediaries with adequate and appropriate feedback to promote AML/CFT compliance.

22.2.1 While the FATF Recommendations require the basic obligations of customer due diligence (CDD), record-keeping and the reporting of suspicion to be set in primary legislation, the more detailed elements for technical compliance may be set in primary legislation or enforceable means (i.e. regulations, guidelines, instructions, or other documents or mechanisms) that set out enforceable requirements in mandatory language with sanctions for non-compliance.

22.2.2 In some jurisdictions the supervisor, while an AML/CFT competent authority, may not be empowered to issue enforceable means; in that case, the supervisor should cooperate and coordinate with the relevant authority holding such power.

22.2.3 The supervisor should require TOs and/or intermediaries to take appropriate steps to identify, assess and understand their ML/TF risks in relation to products (including services and transactions), geography, customers and delivery channels. The supervisor should also require TOs and intermediaries to manage and mitigate the ML/TF risks that have been identified.

22.2.4 The supervisor should promote a clear understanding by TOs and intermediaries of their AML/CFT obligations and ML/TF risks. This may be achieved by engaging with TOs and intermediaries and by providing information on supervision. For example, the supervisor may provide guidance on issues covered under the relevant FATF Recommendations (as implemented in primary legislation or enforceable means), including
possible techniques and methods to combat ML/TF and any additional measures that TOs and/or intermediaries could take to ensure that their AML/CFT measures are effective. Such guidance may not necessarily be enforceable but will assist TOs and/or intermediaries to implement and comply with AML/CFT requirements.

22.2.5 Examples of appropriate feedback mechanisms used by the supervisor may include information on current ML/TF techniques, methods and trends (typologies), sanitised examples of actual ML/TF cases, examples of failures or weaknesses in AML/CFT systems by TOs and intermediaries, and lessons to be learnt. It may be appropriate for the supervisor to refer to guidance or contribute to feedback from other sources – for example, industry guidance and resources made available by the FATF.

### 22.3 The supervisor has an effective supervisory framework to monitor and enforce compliance by TOs and/or intermediaries with AML/CFT requirements.

22.3.1 The supervisor should take into account the risk of ML/TF at each stage of the supervisory process, where relevant, including the licensing stage.

22.3.2 The supervisor should have adequate financial, human and technical resources to combat ML/TF. Staff of the supervisor should be appropriately skilled and provided with adequate and relevant training for assessing and combating ML/TF risks, including the necessary skills and knowledge to assess the quality and effectiveness of a TO’s and intermediary’s AML/CFT systems and controls.

22.3.3 The supervisor should subject TUs and/or intermediaries to supervisory review (off-site monitoring and/or on-site inspection) of their compliance with the AML/CFT requirements and, on the basis of the information arising from such monitoring and any other information acquired, assess the ML/TF risk profile of the TU or intermediary.

22.3.4 The frequency and intensity of supervisory review should be based on:

- the ML/TF risks present in the jurisdiction, including as identified in an NRA, if applicable, or other jurisdiction-wide risk assessment;
- the characteristics of TUs and/or intermediaries – in particular, their number and diversity and the degree of discretion allowed to them under the RBA;
- the ML/TF risks and the policies, internal controls and procedures of each TO and/or intermediary, as identified by the supervisor’s assessment of their ML/TF risk profile; and
- the inherent and residual risks in relation to the particular TU or intermediary based on the firm’s own RBA of its ML/TF risks.

22.3.5 The supervisor should require TOs and/or intermediaries to undertake AML/CFT assessments on a regular basis, and to develop ML/TF risk profiles of their products (including services and transactions), geography, customers and delivery channels. The supervisor should require TOs and
intermediaries to put in place risk management and control measures to effectively address identified risks.

22.3.6 The supervisor should have the power and resources to take proportionate, dissuasive and effective measures (including sanctions and other remedial and corrective measures) where TOs and intermediaries do not implement AML/CFT requirements effectively.

22.3.7 The supervisor should also require TOs and intermediaries to provide regular and timely training in AML/CFT to board members, senior management and other staff as appropriate, which is supported by a communication strategy which ensures that notification of significant changes in AML/CFT policies are regularly and timely provided.

22.3.8 TOs (and, where relevant, intermediaries) should ensure that training in awareness of ML/CF risks and requirements is extended to those responsible for the Shari’ah governance function, and that those engaged in Shari’ah governance are made aware of reporting protocols for suspicious transactions. TOs should also, in the event of detection of ML/CF, consider the implications for Shari’ah compliance, when and to the extent that it is practicable to do so without compromising any legal/regulatory requirements to which the undertaking is subject (e.g. confidentiality and the avoidance of tipping-off).

22.4 The supervisor regularly reviews the effectiveness of the measures that TOs and/or intermediaries and the supervisor itself are taking on AML/CFT. The supervisor takes any necessary action to improve effectiveness.

22.4.1 Reviews should include regular assessment by the supervisor of the effectiveness of implementation by TOs and/or intermediaries of AML/CFT requirements and of its supervisory approach, including the extent to which the supervisor’s actions have an effect on compliance by TOs, TUs and/or intermediaries.

22.4.2 These reviews may cover aspects such as:
- the ML/TF risks of a particular TU and/or intermediary and whether these are adequately addressed by the firm’s RBA;
- the adequacy of resources and training of both the supervisor and the takāful sector;
- whether AML/CFT off-site monitoring is adequate;
- whether the number and content of on-site inspections relating to AML/CFT measures is adequate;
- the findings of off-site monitoring and on-site inspections, including the effectiveness of training and implementation by TOs and intermediaries of AML/CFT measures;
- measures and sanctions taken by the supervisor against TUs and/or intermediaries;
- input from other AML/CFT authorities and the FIU on the takāful sector, such as the number and pattern of suspicious transaction reports made by TOs and/or intermediaries;
• the number and nature of requests for information from other authorities concerning AML/CFT matters;
• the adequacy of the requirements, guidance and other information provided by the supervisor to the takāful sector and feedback received from the takāful sector; and
• the number and type of ML/TF prosecutions and convictions in the takāful sector.

Such reviews should enable the supervisor to identify any necessary actions which need to be taken to improve the effectiveness of the AML/CFT measures being taken by TOs, and/or intermediaries and the supervisor itself.

22.4.3 The supervisor should maintain records on the frequency of off-site monitoring and number of on-site inspections relating to AML/CFT and on any measures it has taken or sanctions it has issued against TUs and/or intermediaries with regard to inadequate AML/CFT measures or non-compliance with AML/CFT requirements.

22.5 The supervisor has effective mechanisms in place which enable it to cooperate, coordinate and exchange information for AML/CFT purposes with other domestic authorities as well as with supervisors in other jurisdictions.

22.5.1 Effective prevention and mitigation of ML/TF is enhanced by close cooperation within a supervisor’s organisation and among supervisors, the FIU, law enforcement agencies and other relevant authorities. Mechanisms of cooperation, coordination and exchange of information among relevant authorities should be documented, and normally address:
• operational cooperation and, where appropriate, coordination; and
• policy cooperation and, where appropriate, coordination.

22.5.2 Where the supervisor identifies suspected ML/TF in TUs or intermediaries, it should ensure that relevant information is provided in a timely manner to the FIU, any appropriate law enforcement agency and other relevant authorities.

22.5.3 The supervisor should take all necessary steps to cooperate, coordinate and exchange information with the other relevant authorities. The supervisor should communicate with the FIU and appropriate law enforcement agency to ascertain any concerns it has and any concerns expressed on AML/CFT compliance by TUs and intermediaries, to obtain feedback on trends in reported cases, and to obtain information regarding potential ML/TF risks to the takāful sector.

22.5.4 In the case of takāful, the supervisor may need to seek cooperation from relevant religious authorities on matters such as waqf and zakat where suspicious transactions or key controls for effective prevention and mitigation of ML/TF impinge upon the activities of such authorities.
22.5.5 To promote an efficient exchange of information, the supervisor should consider identifying within its office a point of contact for AML/CFT issues and to liaise with other relevant authorities.

22.5.6 The exchange of information for AML/CFT purposes is subject to confidentiality considerations (see TCP 3: Information Sharing and Confidentiality Requirements).

Part B: Where the Supervisor is Not a Designated AML/CFT Competent Authority

22.6 The supervisor is aware of and has an understanding of ML/TF risks to which TUs and/or intermediaries are exposed. The supervisor liaises with and seeks to obtain information from the designated competent authority relating to AML/CFT by TOs and intermediaries.

22.6.1 The supervisor should have an understanding of the ML/TF risks to which TUs and/or intermediaries are exposed arising from activities undertaken in relation to products (including services and transactions), geography, customers and delivery channels, and the jurisdiction's approach to assessing and mitigating them.

22.6.2 To enhance such understanding, it is helpful if the supervisor has access to the NRA, if applicable, or other jurisdiction-wide risk assessment.

22.6.3 The supervisor should be able to make a more informed evaluation and judgment on the soundness of TUs and intermediaries by receiving information from the designated AML/CFT competent authority. Such information may be relevant to the risk profile of, or to the effectiveness of risk management by, a TU, TO or intermediary. The contents of this information may include the level of ML/TF risks to which TUs and/or intermediaries are exposed, and the designated competent authority’s views on the corporate governance, risk management and internal control measures of supervised entities relevant to AML/CFT.

22.6.4 The designated AML/CFT competent authority may have information on breaches of AML/CFT requirements that should be taken into consideration by the supervisor in its supervisory activities, such as when evaluating the suitability of the board, senior management and key persons in control functions, including when reviewing licence applications.

22.7 The supervisor has effective mechanisms in place which enable it to cooperate, coordinate and exchange information for AML/CFT purposes with relevant domestic authorities as well as with supervisors in other jurisdictions.

22.7.1 Effective prevention and mitigation of ML/TF is enhanced by close cooperation within a supervisor’s organisation and among supervisors, the FIU, law enforcement agencies and other relevant authorities. Mechanisms of cooperation, coordination and exchange of information among relevant authorities should be documented and normally address operational cooperation and, where appropriate, coordination.
22.7.2 When the supervisor becomes aware of information on ML/TF risks, it should provide relevant information to the designated AML/CFT competent authority. When the supervisor identifies suspected ML/TF in TUs and/or intermediaries, it should ensure that relevant information is provided to the FIU, appropriate law enforcement agencies and any relevant supervisors.

22.7.3 As part of its cooperation with the designated AML/CFT competent authority, the supervisor should provide input into the effectiveness of the AML/CFT framework. This may help the designated competent authority in its consideration of the framework’s effectiveness.

22.7.4 The exchange of information for AML/CFT purposes is subject to confidentiality considerations (see TCP 3: Information Sharing and Confidentiality Requirements).

TCP 23: GROUP-WIDE SUPERVISION

The group-wide supervisor, in cooperation and coordination with other involved supervisors, identifies the insurance group and determines the scope of group supervision.

Introductory Guidance

23.0.1 A *takāful* supervisor may be brought within the scope of this TCP by reason of acting as the group-wide supervisor (because the group is solely engaged in *takāful* business, or the head of the group or the largest operation is a TU, or otherwise by agreement with other involved supervisors) or by reason of acting as supervisor of a TU (legal entity or window) that is a member of a group. It may have both roles, if it is the group-wide supervisor of a *takāful* group that is itself a subgroup of a wider insurance group or financial conglomerate.

23.0.2 The principal focus of this TCP is the insurance group, which may be a group conducting solely *takāful* business, or conducting also conventional insurance business. Group-wide supervision allows the supervisors of the undertakings to cooperate and coordinate in supervision of aspects of Islamic and conventional insurance business that are in common, as well as permitting the supervisors of each type of insurance to focus on the specificities of that type. It assists supervisors in identifying and assessing intra-group transactions, linkages and relationships so as to gain a better understanding of the financial position, risk profile and quality of governance, including where relevant Shari’ah governance, of group members.

23.0.3 Involved supervisors should seek agreement among themselves on the identification of the insurance group, including the head of the insurance group, and the scope of group-wide supervision to ensure that gaps or duplication in regulatory oversight between jurisdictions do not occur. If
agreement cannot be reached in a timely manner, the ultimate responsibility for determining the identification of the insurance group and scope of group-wide supervision rests with the group-wide supervisor. Decisions should be undertaken on a case-by-case basis and may include discussion with the insurance group.

23.0.4 The group-wide supervisor cooperates and coordinates with other involved supervisors, and should be accountable for the appropriateness of the identification of the insurance group and the determination of the scope of group supervision. In particular, in the case of insurance groups that operate on a cross-border basis, the group-wide supervisor should be able to explain the appropriateness of the identification of the insurance group and the determination of the scope of group supervision to involved supervisors in other jurisdictions. Also, where the group includes both Islamic insurance and other business (whether or not insurance), the group-wide supervisor should be able to explain the determination of the scope of group supervision so far as concerns matters of relevance to the supervision of TUs (e.g. Sharīʻah governance arrangements) to the involved supervisors. An involved supervisor responsible for the supervision of takāful should request such an explanation, where necessary. The identification of the insurance group and scope of group supervision should be reviewed regularly by the group-wide supervisor, in cooperation and coordination with other involved supervisors.

23.0.5 The group-wide supervisor should require the head of the insurance group to provide information needed on an ongoing basis to identify the insurance group and to determine the scope of group-wide supervision. The head of the insurance group provides the information to the group-wide supervisor, who disseminates it to the other involved supervisors as needed.

23.0.6 The information to be provided by the head of the insurance group should include information related to Sharīʻah governance at group level (where relevant) and in material group members, including information on structures and processes designed to ensure Sharīʻah compliance in group members where that is required.

23.1 The group-wide supervisor, in cooperation and coordination with other involved supervisors, identifies all legal entities that are part of the insurance group.

23.1.1 To ascertain the identity of an insurance group, supervisors should first identify all TUs and conventional insurance legal entities within the corporate structure.

23.1.2 Supervisors should then identify all entities which have control over those TUs and conventional insurance legal entities in the meaning provided for in the definition in TCP 6: Changes in Control and Portfolio Transfers. If this results in only one identified entity, this entity is the head of the insurance group. If there is more than one entity with control over the TUs and conventional insurance legal entities, supervisors should
identify the head of the insurance group such as the entity which has the greatest level of control over the takāful and conventional insurance business.

23.1.3 A practical method for determining the entities within the insurance group is often to start with entities included in the consolidated accounts. The head of an insurance group including an insurance-led financial conglomerate is at least one of the following:
- a TU or conventional insurance legal entity; or
- a holding company.

The identified insurance group includes the head of the insurance group and all the legal entities controlled by the head of the insurance group. Legal entities within a group could include:
- operating and non-operating holding companies (including intermediate holding companies);
- other regulated entities such as banks and/or securities companies;
- non-regulated entities; and
- special purpose entities.

In addition to considering the consolidated accounts, the supervisor should consider other relationships, such as:
- common directors;
- membership rights in a mutual or similar entity;
- involvement in the policy-making process; and
- material transactions.

The insurance group may be:
- a subset/part of a bank-led or securities-led financial conglomerate (in either case, whether conventional or Islamic); or
- a subset of a wider group, such as a larger diversified conglomerate with both financial and non-financial entities.

23.1.4 Examples of the types of group structures that could be captured by the definition of insurance groups are provided in Figures 23.1, 23.2, 23.3 and 23.4. These examples are for purposes of illustration only, and are not intended to set forth all possible forms of insurance groups.

23.1.5 In identifying the group, control is determinative. For simplicity, the distinction between conventional and Islamic financial services (which is not itself determinative for this purpose) is not reflected in the diagrams. Thus, an insurance group may include either or both conventional and Islamic insurance legal entities, and a financial conglomerate may include a mix of conventional and Islamic insurance and banking and/or securities legal entities.

23.1.6 The TCPs’ definition of “insurance group” may be different from the definitions used in other contexts, such as accounting or tax purposes.
Illustration to Assist the Identification of Insurance Groups

Figure 23.1 Insurance Group

Insurance Group

Head of the Insurance Group

Conventional Insurance or *Takāful* Legal Entity

Conventional Insurance or *Takāful* Legal Entity

Non-regulated Subsidiary

Figure 23.2 Financial Conglomerate

Financial Conglomerate

Head of Financial Conglomerate

Conventional and/or Islamic Securities Subgroup

Non-regulated Subsidiary

Conventional and/or Islamic Banking Subgroup

Non-regulated Subsidiary

Insurance Group

Insurance Holding Company

Conventional Insurance or *Takāful* Legal Entity

Conventional Insurance or *Takāful* Legal Entity

Non-regulated Subsidiary
Figure 23.3 Insurance-Led Financial Conglomerate

Insurance-Led Financial Conglomerate

Head of the Financial Conglomerate,
Head of the Insurance Group

Conventional Insurance or Takāful Legal Entity

Non-regulated Subsidiary

Banking Group
Banking Holding Company

Conventional and/or Islamic Banking Legal Entity

Non-regulated Subsidiary

Securities Group
Securities Holding Company

Conventional and/or Islamic Securities Legal Entity

Non-regulated Subsidiary
Figure 23.4 Wider Group

Wider Group

- Wider Group Holding Company
- Manufacturing Subgroup
- Retail Subgroup

Financial Conglomerate Holding Company

- Conventional and/or Islamic Securities Subgroup
- Conventional and/or Islamic Banking Subgroup

Non-regulated Subsidiary

Insurance Group

- Insurance Holding Company (Head of the Insurance Group)
- Conventional Insurance or Takāful Legal Entity
- Conventional Insurance or Takāful Legal Entity
- Non-regulated Subsidiary
23.2 The group-wide supervisor, in cooperation and coordination with other involved supervisors, determines the scope of group-wide supervision.

23.2.1 Involved supervisors should consult and agree on the scope of group-wide supervision of the insurance group to ensure that there are no gaps and no unnecessary duplication in supervision among jurisdictions.

23.2.2 A practical method to determine the entities to capture within the scope of group-wide supervision is to start with entities included in the consolidated accounts. Entities that are not included in consolidated accounts should be included if they are relevant from the perspective of risk (non-consolidated entities also subject to supervision) or control. The entities that may be captured within the scope of group-wide supervision may either be incorporated or unincorporated.

23.2.3 In considering the risks to which the insurance group is exposed, it is important to take account of those risks that emanate from the wider group within which the insurance group operates.

23.2.4 Individual entities within the insurance group may be excluded from the scope of group-wide supervision if the risks from those entities are negligible or group-wide supervision is impractical.

23.2.5 The exclusion or inclusion of entities within the scope of group-wide supervision should be regularly reassessed.

23.2.6 It should be noted that the supervisory approach to entities/activities within the insurance group may vary depending on factors such as their types of business, legal status, and/or nature, scale and complexity of risks. Although an insurance group as a whole should be subject to group-wide supervision, not all quantitative and qualitative supervisory requirements applied to a TU or conventional insurance legal entity should necessarily be applied to other entities within the group, to the insurance group as a whole, or to a subgroup collectively.

23.2.7 For example, conventional insurance legal entities within the group (other than any takāful windows that they host) do not share specificities of TUs within the insurance group, such as requirements for Shari’ah governance and the implications for the TU if Shari’ah non-compliance occurs. Accordingly, related supervisory requirements would not be expected to be applied on a group-wide basis, but would be applied to TUs on a solo basis (and, potentially, at takāful subgroup level should a solely takāful subgroup exist within the group). If Shari’ah non-compliance risk is material to the group (e.g. because material group members would be destabilised by the discovery of widespread Shari’ah non-compliance), the group-wide supervisor would be expected to have greater involvement in this aspect of supervision of the group’s operations.
23.3 The group-wide supervisor and other involved supervisors do not narrow the identification of the insurance group or the scope of group-wide supervision due to lack of legal authority or supervisory power over particular legal entities.

23.3.1 In some jurisdictions, the supervisor may not be granted legal authority or supervisory power for the direct supervision of some entities within the identified insurance group or the scope of group-wide supervision. These may include legal entities regulated in another sector or non-regulated entities within the same jurisdiction.

23.3.2 Where a supervisor has no direct legal power over certain legal entities in the scope of the group-wide supervision, the supervisor will use its power over regulated entities and/or consult with other involved supervisors to obtain similar supervisory outcomes.

TCP 24: MACROPRUDENTIAL SUPERVISION

The supervisor identifies, monitors and analyses market and financial developments and other environmental factors that may impact TUs and the takāful sector, uses this information to identify vulnerabilities and to address, where necessary, the build-up and transmission of systemic risk at the individual TU and sector-wide levels.

Introductory Guidance

24.0.1 This TCP focuses on the general processes and procedures supervisors should have in place with respect to macroprudential supervision, as part of the overall supervisory framework (see TCP 10: Supervisory Review and Reporting). A jurisdiction’s macroprudential supervision processes and procedures should be proportionate to the nature, scale and complexity of its takāful sector’s exposures and activities.

24.0.2 Macroprudential supervision is relevant to takāful, as the takāful sector performs a function of risk intermediation and financial intermediation. Its overall stability is one aim of prudential supervision. In jurisdictions where both Islamic and conventional insurance are practised, takāful forms a part of an insurance sector including both types, whose stability is similarly an aim of policymakers. This insurance sector also forms a part of the broader financial system. Takāful supervisors therefore conduct macroprudential supervision, often also in the context of a broader insurance sector and always in the context of the broader financial system, if necessary in consultation with other supervisors involved in the financial sector.

24.0.3 Macroprudential supervision consists of data collection, market and trend analysis, systemic risk assessment, supervisory response and transparency. It identifies and, where necessary, addresses both vulnerabilities of individual TUs and the takāful sector to shocks (inward
risks) and the build-up of systemic risk at the individual TU level or the sector as a whole (outward risks). Inward risks include *takāful*, insurance and financial market developments, which may impact the *takāful* sector. “Outward risks” refers to the risks that individual TUs or the *takāful* sector may pose to the financial system and the real economy. Macroprudential supervision contributes to financial stability by minimising the incidence and impact of externalities on the financial system and real economy generated or amplified through the distress or default of individual TUs or common behaviours.

24.0.4 Macroprudential supervision involves the identification, monitoring and assessment of:
- sector-wide vulnerabilities and common exposures in the *takāful* and conventional insurance sector; and
- the risk of amplification and transmission of shocks to the financial system and real economy caused by:
  - the size, complexity, lack of substitutability and/or interconnectedness of a distressed or failing TU (e.g. where a TU is a material subsidiary of a conventional insurer or of a bank); or
  - collective actions or distress of a sufficiently large number of TUs and conventional insurers undertaking similar activities and thus exposed to common risks.

24.0.5 “Systemic risk” may be defined as the risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy. Systemic impact may originate from individual or sector-wide exposures to liquidity risk, interconnectedness (macroeconomic and counterparty exposure), including between TUs and conventional insurers and reinsurers, or lack of substitutability, as well as from other risks. These risks may spread to other parts of the financial system via asset liquidation, exposures or critical functions.

24.0.6 Risks specific to the *takāful* sector may also have the potential for contagion within that sector, resulting in instability in the *takāful* sector and the risk of wider propagation to other parts of the financial system that are not directly affected by those risks. For example, unforeseen restrictions in the availability of Sharīʻah-compliant investment assets of appropriate quality and tenor would affect the *takāful* sector, potentially resulting in solvency and liquidity crises that could affect the stability of the broader insurance sector, through, for example, failure of a window (or simply connection with failure in the public mind) or of the broader financial sector through interconnectedness such as credit protection provided on a *takāful* basis. Another example might be a loss of public confidence in the Sharīʻah compliance of practices of some TOs in a jurisdiction, destabilising the *takāful* sector and having knock-on impacts in other parts of the financial sector.
Macroprudential supervision can help to identify the need for supervisory measures. In its macroprudential supervision, the supervisor should also take into account the material risks that non-*takāful* and non-insurance legal entities and activities may pose to TUs, insurance groups and the wider financial system.

The supervisory framework should allow the supervisor to respond in a timely manner to findings from the analysis performed as part of its macroprudential supervision.

Data Collection for Macroprudential Purposes

The supervisor collects data necessary for its macroprudential supervision.

24.1 Data collection for macroprudential purposes should take into account the following general aspects:

- **Efficiency of data collection:** The supervisor should examine costs and benefits when considering data collection. Data collections should be aligned with their respective usage. The supervisor should first make use of all available data sources and then calibrate its data requests and data processing capabilities.

- **Data validation:** Before analysing data and providing recommendations on the findings, the supervisor should validate data used in its assessment.

- **Data quality assurance:** The supervisor should regularly evaluate the appropriateness of data collected and data needs to capture market developments and address deficiencies in:
  - the type of data collected;
  - its ability to process data in a timely and/or complete way; and
  - its ability to collect ad hoc data in a timely manner.

- **Scope:** For sector-wide assessments, data collection should cover a representative sample of the respective market or risk.

- **Consistency:** Regular data collections of a standardised set of information should remain consistent over time in order to analyse trends. The supervisor should, however, consider the evolving nature of the relevant exposures.

- **Ad hoc data collection:** In order to address emerging risks, the supervisor should have processes in place that allow for ad hoc data collections.

24.1.2 To support the assessment of liquidity risk, the supervisor should collect data that provide sufficient indications on possible liquidity mismatch between assets and liabilities both at the individual and the sector-wide level. Reporting requirements on liabilities should include, but not be limited to, information on the surrender value of insurance products, product features that increase or decrease the propensity for early pay-outs under certain circumstances (such as penalties or delays in the ability to access the cash value of a policy), and the maturity or redemption
structure of non-insurance liabilities. On the asset side, information on the
degree of liquidity of the assets should be collected.

24.1.3 To support the assessment of macroeconomic exposure, the supervisor
should collect data that are sufficiently granular to enable an analysis of a
TU’s, as well as the takāful sector’s, vulnerability to macroeconomic
shocks (such as sensitivity to movements in rates of return) and general
market movements (such as sensitivity to equities and other asset
movements).

24.1.4 To support the assessment of counterparty risk, the supervisor should
collect data that include the concentration of the assets and liabilities, with
regard to counterparties, markets (such as equity or sukuk), sectors (such
as financial or real estate), and geographical areas.

24.1.5 The supervisor should collect microeconomic data, such as takāful pricing,
underwriting, expenses, claims inflation, retakāful, conventional
reinsurance, intra-group transactions, and general developments in the
takāful sector (e.g. the development of claims, earned profit rates,
reserves, pandemics, and changes in morbidity and mortality, longevity,
changes in the frequency and severity of catastrophes, changes in
medical expense inflation and changes in law). In addition, the supervisor
may collect data on both the asset and the liability structure of TUs,
including those that are related to non-takāful activities. The supervisor
should consider having established processes and communication
channels on microeconomic data collection with other involved
supervisors when a TU operates in multiple jurisdictions.

24.1.6 The supervisor should collect macroeconomic data to complement
information mainly gathered as a result of supervisory reporting. Data may
include general domestic and international macroeconomic variables (such
as discount rates, exchange rates, inflation or balance of payments, as well
as data on market structure and competitiveness) which could identify
macroeconomic instabilities and sources of risk both in the domestic and
the global economy. Macroeconomic data may be used to assess the
exposure of TUs’ portfolios of both assets and liabilities to economy-wide
factors. For TUs operating in multiple jurisdictions, the supervisor should
consider collecting relevant macroeconomic data for material jurisdictions.

**Takāful Sector Analysis**

24.2 The supervisor, as part of its macroprudential supervision, performs
analysis of financial markets and the takāful sector that:
• is both quantitative and qualitative;
• considers historical trends as well as the current risk environment; and
• considers both inward and outward risks.

24.2.1 To enable macroprudential supervision, the supervisor should have
processes and procedures in place that would allow for analysis on takāful
sector trends that could potentially result in externalities to the wider
financial system and/or adversely impact the takāful sector. These trends include changes in economic conditions and technology, as well as environmental, social and governance developments. Such processes and procedures should also recognise that changes in the exposures of TUs can potentially have macroprudential risk implications.

24.2.2 The supervisor considers the impact of the differentiated business model of TUs, assessing idiosyncratic risks of such undertakings and the takāful sector and their effect on the build-up and transmission of systemic risks with the broader insurance sector, where relevant.

Quantitative and Qualitative Analysis

24.2.3 Quantitative analysis includes identifying trends, outliers, interconnectedness and/or risk concentrations of existing or newly identified vulnerabilities. Typical methods of quantitative analysis may include:

• horizontal reviews;
• descriptive statistics;
• trend analysis; and
• statistical modelling using past data.

24.2.4 Qualitative analysis includes performing assessments based on judgment, experience, information and any other factors that cannot be either measured or quantified with typical methods. Qualitative analysis may be particularly relevant for the assessment of low-probability, high-impact type of events with limited quantifiable data available.

24.2.5 The supervisor should conduct horizontal reviews to reveal the range of practices among TUs and conventional insurers relevant to a common subject (e.g. the assessment of the appropriateness of TUs’ and conventional insurers’ assumptions used for reserving). A horizontal review may help to determine which TUs or conventional insurers are outliers, and as such provides the supervisor with a reference for potential further actions. A horizontal review may provide an aggregated view of the risks linked to certain exposures and/or activities and may also help determine whether industry practice as a whole is effective enough to address the risks embedded in the activity.

24.2.6 To make horizontal reviews effective, the following may be taken into account:

• Where peer groups are used, the choice of the peer group can have an impact on the outcome of the review. The supervisor should carefully consider the criteria for including TUs in a peer group.
• When reviewing a TU operating in multiple jurisdictions, the group-wide supervisor should form a group-wide perspective. Such a perspective can build on analyses performed by a peer authority or a third party (including international organisations such as the IFSB, IAIS, IMF and World Bank).
• The results of horizontal reviews performed within a single jurisdiction can be beneficial to the supervisory community as a whole, especially as they may relate to systemic risk to the takāful sector and the broader insurance sector. The supervisor may also consider suitable fora for the communication of information that is not necessarily takāful- or TU-specific.

• Horizontal reviews need not always be complex exercises. Simple horizontal outlier analysis on readily available TU reports can often provide helpful supervisory insight. Simple analysis of some of these reports, including trends and peer comparisons, may help the supervisor to identify areas of potential risk and to target future work. For example, analysis of the adequacy of wakālah fees received by the SHF compared to management expenses borne by the TO, where segregation of funds is practised, may assist in assessing the viability of the commercial model or models adopted by TOs in the jurisdiction.

Historic Trends and Current Risk Environment

24.2.7 The supervisor should have in place an appropriate form of stress testing, which is applied to the takāful sector as a whole or to a significant sub-sample of TUs, selected according to the exposures to specific risks to be assessed. Outcomes of takāful sector, conventional insurance sector and financial market analysis should be considered in the development of severe but still plausible scenarios to be tested in such exercises. Scenarios should reflect the current market environment and potential unfavourable evolutions in terms of changes in markets and takāful-specific risk exposures. In order to contextualise the results, the supervisor should take into account the characteristics of the supervisory framework and the structure of the TU's assets and liabilities. Following a stress test exercise, the supervisor should discuss potential vulnerabilities and potential mitigating actions with the relevant TUs.

24.2.8 While many data items are backward looking, takāful sector analysis should be forward looking, to the extent possible, when developing scenarios to capture potential future developments. Stress scenarios should take into account ways that market dynamics have changed, which may make historical data less relevant.

24.2.9 The supervisor should use stress tests to identify vulnerabilities and risks and assess the impacts to the takāful sector and for individual TUs. Additionally, stress scenarios should be used to identify how those potential impacts may spread.

24.2.10 Stress testing may be applied separately to the takāful sector, and this should in any case occur where stresses are identified that are specific to the takāful sector. The supervisor should also consider the impact of any such stresses on the takāful sector as a whole and the broader financial sector.
Inward and Outward Risks

24.2.11 When assessing both inward and outward risks, the supervisor should assess TUs’ exposures to liquidity risk, interconnectedness (macroeconomic and counterparty exposure), lack of substitutability and other risks. Assessing “inward risks” refers to the extent that TUs may be exposed to, or vulnerable to, a certain risk within the takāful sector, whereas “outward risk” refers to the situation in which these vulnerabilities would generate externalities which may then propagate to other financial markets or the real economy.

24.2.12 The supervisor should monitor the liquidity of a TU’s invested assets relative to its takāful liabilities based on their characteristics. Additionally, the supervisor should analyse the potential that a large takāful’s operations could require it, or a sufficiently large number of TUs, to engage in asset sales of a significant size. The supervisor should assess the funding structure of TUs and their reliance on short-term funding.

24.2.13 The supervisor should monitor interconnectedness with the financial system (e.g. via intra-financial assets and liabilities or derivatives). As these exposures can be on a cross-jurisdictional and cross-sectoral basis, the supervisor should cooperate with supervisors in other relevant jurisdictions and sectors.

24.2.14 Macroeconomic exposure in takāful liabilities depends on the characteristics of applicable investment guarantees as well as other contractual provisions and the complexity of the underlying risks. Monitoring of macroeconomic exposure should recognise the relationship between the assets and liabilities of the TU. Stress tests can be used to support monitoring of this exposure.

Assessing Systemic Importance

24.3 The supervisor has an established process to assess the potential systemic importance of individual TUs and the takāful sector.

24.3.1 The supervisor should take a total balance sheet approach (see TCP 16: Enterprise Risk Management for Solvency Purposes) when considering the potential systemic importance of a TU. When analysing systemic risk stemming from the takāful sector, the supervisor should at least consider common exposures and activities.

24.3.2 The supervisor should consider the type of policies underwritten by TUs and the activities TUs are engaged in, such as the degree of engagement in derivatives activity and reliance on short-term market activity. The supervisor should also consider the interconnectedness with other financial institutions, and the role of the takāful sector within the broader financial system.
24.3.3 As part of its assessment, the supervisor should consider emerging developments that may affect the takāful sector’s risk exposures. Additionally, the supervisor should cooperate and coordinate with conventional insurance and other financial sector supervisors (such as banking, securities and pension supervisors, central banks and government ministries) to gain additional perspectives on the potential change in the risk exposures of TUs stemming from evolutions of other markets.

24.3.4 The supervisor should communicate the findings of its assessment, as appropriate, to either individual TUs or the sector. The supervisor should require TUs to take action necessary to mitigate any particular vulnerabilities that have the potential to pose a threat to financial stability.

**Supervisory Response**

24.4 The supervisor uses the results of its macroprudential supervision, and considers the potential systemic importance of TUs and the takāful sector, when developing and applying supervisory requirements.

24.4.1 A macroprudential perspective in the development and application of supervisory requirements may help limit the build-up of systemic risks and contribute to the resilience of the financial system. The supervisor should ensure that there is an appropriate interaction between its macroprudential analysis and assessment activities, on the one hand, and microprudential supervision, on the other hand.

24.4.2 As part of introducing supervisory requirements into its supervisory framework, the supervisor should consider implementing supervisory measures based on macroprudential concerns. Many macroprudential tools are, in effect, microprudential instruments developed or applied with a macroprudential perspective in mind. By mitigating risk exposures, some measures that are intended to protect takāful participants may also contribute to financial stability by decreasing the probability and magnitude of any negative systemic impact.

24.4.3 The supervisor should determine the depth and level of supervision based on its assessment of the systemic importance of individual TUs or the takāful sector (see TCP 10: Supervisory Review and Reporting). The supervisor should act to reduce systemic risk when identified within its jurisdiction through an appropriate supervisory response. In jurisdictions where one or more TUs have been assessed as systemically important, or a number of TUs are contributing to systemic risk, the supervisor should have supervisory requirements targeted at those TUs to mitigate systemic risk. The supervisor should extend certain requirements as necessary to a TU and/or a number of TUs that it has assessed to be systemically important.

24.4.4 Specific supervisory responses may relate to:
• requirements on TOs:
  o enterprise risk management (see TCP 16: Enterprise Risk Management for Solvency Purposes); and
  o disclosures (see TCP 20: Public Disclosure);

• preventive or corrective measures (see TCP 11: Preventive Measures, Corrective Measures and Sanctions); and

• crisis management and planning:
  o crisis management, including crisis management groups (see TCP 25: Supervisory Cooperation and Coordination); and
  o recovery and resolution planning (see TCP 12: Exit from the Market and Resolution and TCP 16: Enterprise Risk Management for Solvency Purposes).

24.4.5 Supervisory requirements may be intended to mitigate the potential spillover effects from the distress or disorderly failure of an individual TU or from the common exposures or behaviours of a group of TUs and/or conventional insurers or across the sector. In the latter case, supervisory requirements may have different effects during different phases of the economic, underwriting or credit cycle. Therefore, the supervisor may develop requirements that are time-varying in nature, depending on the economic environment. The activation of such time-varying requirements could be rules-based (e.g. triggered automatically given a pre-defined condition) or discretionary (i.e. upon explicit decision by the supervisor). A rules-based approach may be more transparent but requires regular assessments of its adequacy under changing conditions affecting the takāful business.

Transparency

24.5 The supervisor publishes relevant data and statistics on the takāful sector.

24.5.1 The publication of data and statistics by the supervisor may enhance market efficiency by allowing market participants to make more informed decisions and reducing the cost to the public of acquiring takāful sector information. Moreover, the publication of data may serve as a market disciplining mechanism by facilitating comparisons of an individual TU to the sector as a whole.

24.5.2 The supervisor may provide access to sufficiently detailed data either by publishing data itself or by providing others with adequate means for publishing data. This could be achieved by engaging a government statistical office or cooperating with the local takāful sector; provided the supervisor is satisfied with the accuracy, completeness, frequency and timeliness of such publication.
TCP 25: SUPERVISORY COOPERATION AND COORDINATION

The supervisor cooperates and coordinates with involved supervisors and relevant authorities to ensure effective supervision of TUs operating on a cross-border basis.

Introductory Guidance

25.0.1 A takāful supervisor may be brought within the scope of this TCP by reason of acting as the group-wide supervisor of a cross-border insurance group (because the group is solely engaged in takāful business, or the head of the group or the largest operation is a TU, or otherwise by agreement with other involved supervisors) or by reason of acting as supervisor of a TU (legal entity or window) that is a member of an insurance group operating on a cross-border basis.

25.0.2 Supervisors of the different TUs and/or conventional insurance legal entities within an insurance group with cross-border activities should coordinate and cooperate in the supervision of the insurance group as a whole. Supervisors of different TUs and/or conventional insurance legal entities which are not part of the same group may also need to cooperate and coordinate particularly where the TUs are connected through retakāful or conventional reinsurance treaties or when difficulties in one TU or conventional insurer may affect the market more generally, such as in resolution situations (see TCP 12: Exit from the Market and Resolution).

25.0.3 Supervisors may draw upon several supervisory practices to facilitate cross-border cooperation and coordination. These practices include the identification of a group-wide supervisor and the use of coordination arrangements, including supervisory colleges.

25.0.4 The group-wide supervisor is one of the involved supervisors and is chosen to lead group-wide supervision of an insurance group. The group-wide supervisor should facilitate and lead the cooperation and coordination between the other involved supervisors and engage them in the relevant supervisory decisions regarding the insurance group. The group-wide supervisor is ultimately responsible for delivering effective and efficient group-wide supervision. The other involved supervisors should provide the group-wide supervisor with information regarding TUs and/or conventional insurance legal entities they supervise and otherwise participate in group-wide supervision. The procedures for systematic or ad hoc information exchange should be agreed with the other involved supervisors. The sharing of information by the group-wide supervisor and the other involved supervisors should be subject to confidentiality requirements (see TCP 3: Information Sharing and Confidentiality Requirements).

25.0.5 The undertaking of cooperation and coordination should not be taken to imply joint decision-making authority or any delegation of an individual supervisor’s responsibilities. Supervisory decisions remain within the responsibility of each of the involved supervisors.
Supervisory Recognition

25.0.6 Supervisors wishing to determine whether they can recognise and rely upon another supervisory regime for the purpose of group-wide supervision and designation of supervisory tasks should carry out an assessment of the acceptability of the counterpart’s regime reflecting the level or objective of supervisory recognition sought. Supervisors may use different processes to conduct a supervisory recognition assessment. The form of recognition and the criteria used for assessment will vary depending on its purpose.

25.0.7 When the assessment has been finalised, the decision as to whether to recognise the supervisor should be communicated to the subject of the assessment. If recognition is not possible, the areas where the criteria were not met should be communicated and the supervisors should discuss how recognition may be achieved in future. A process for reassessment could then be established.

25.0.8 Following recognition, the supervisor should periodically assess whether a recognised supervisor continues to meet the criteria for recognition.

25.0.9 The terms of supervisory recognition, as well as specific roles and responsibilities, may be set out in unilateral statements, bilateral agreements or multilateral agreements.

25.1 The supervisor discusses and agrees with the involved supervisors which of them is the group-wide supervisor for cross-border insurance groups operating in its jurisdiction.

25.1.1 In principle, the home supervisor of the head of the insurance group should be considered first to take the role of the group-wide supervisor in accordance with its authority and powers in its jurisdiction. In some jurisdictions, the legal or regulatory system may include provisions which allow or require the designation of a group-wide supervisor.

25.1.2 In case a different or several involved supervisors fulfil the conditions to be considered as a group-wide supervisor, factors to consider regarding the identification of a group-wide supervisor should include:

- the location of the insurance group’s head office, given that this is where the group’s board and senior management is most likely to meet;
- where the registered head office is not the operational head of the insurance group, the location where:
  - the main business activities are undertaken;
  - the main business decisions are taken;
  - the main risks are underwritten; and/or
  - the largest balance sheet total is located; and
- the involved supervisors’ resources, skills, authorities and powers in their jurisdictions.
25.2 As a group-wide supervisor, the supervisor:
• understands the structure and operations of the insurance group; and
• leads group-wide supervision, taking into account assessments made by the other involved supervisors.

**Overall Responsibilities of a Group-Wide Supervisor**

25.2.1 Once identified, the group-wide supervisor should be responsible for coordinating the input of supervisors of TUs and/or conventional legal entities in undertaking group-wide supervision as a supplement to the existing supervision of each TU and/or conventional insurance legal entity.

25.2.2 Responsibilities of the group-wide supervisor should include:
• chairing of the supervisory college (where one exists), or consider establishing one if not in place yet;
• determination of the scope of group supervision;
• leadership, planning and coordination of group-wide supervisory activities;
• aggregation of group-wide information and dissemination of the relevant information to the other involved supervisors;
• preparation and discussion of group-wide supervisory analysis;
• performing a group-wide supervisory assessment, including assessing group capital management, risk and solvency, risk concentration, intra-group transactions, group governance and, where relevant, group Shari’ah governance;
• coordination of information-sharing procedures among other involved supervisors;
• decision making on group-wide issues in consultation with other involved supervisors, where relevant;
• implementation and coordination of decisions on group-wide issues, including preventive and corrective measures and sanctions; and
• identification of gaps in supervision.

25.2.3 The group-wide supervisor should take the initiative in coordinating the roles and responsibilities of, and facilitating communication between, the other involved supervisors. In carrying out its agreed functions, the group-wide supervisor should strive to act with the consensus of the other involved supervisors.

**Information Sharing and Key Contact Point Function**

25.2.4 The group-wide supervisor should request information from other involved supervisors needed to fulfil its role.

25.2.5 The group-wide supervisor should make relevant information available to the other involved supervisors on a proactive basis and in a timely manner.

25.2.6 The group-wide supervisor functions as a key contact point for all other involved supervisors.
25.3 As an “other involved supervisor”, the supervisor understands:

- the structure and operations of the group in so far as it concerns the TUs in its jurisdiction; and
- the way that operations of TUs of the group in its jurisdiction may affect the rest of the group.

Responsibilities

25.3.1 Responsibilities of other involved supervisors should include:

- actively participating in the group supervision process, such as that facilitated by a supervisory college;
- informing the group-wide supervisor and, if necessary, other involved supervisors, of material findings affecting their TU that could affect entities in their own or other jurisdictions;
- sharing all relevant information with the group-wide supervisor to assist with supervision at the group-wide level and discussing findings and concerns at the group level with the group-wide supervisor;
- analysing information received from the group-wide supervisor;
- cooperating in the analysis and decision making as well as implementation and enforcement;
- assisting the group-wide supervisor in carrying out the supervisory process at the group level; and
- identifying gaps in supervision.

Information Sharing

25.3.2 Other involved supervisors should provide the group-wide supervisor with relevant information, regarding insurance legal entities within the insurance group, including:

- any granting and withdrawal of a licence;
- location of significant business;
- developments in the legal structure of the insurance group;
- changes in business model;
- changes in the takāful model of a TU;
- changes to the board or senior management;
- changes to the Shari‘ah board or to senior persons responsible for Shari‘ah governance functions;
- changes in the systems of risk management and internal controls, including systems related to Shari‘ah governance;
- significant developments or material changes in the business operations;
- significant developments in the financial position and regulatory capital adequacy, including (where segregation of funds is practised) at the level of the fund;
- earmarking, advancement, release or repayment of qard between funds of a TU, where significant;
- significant investments in group legal entities;
- significant financial links;
• the transfer or sharing of risks to and from non-regulated legal entities;
• significant changes in the transfer or sharing of risks to and from conventional and Islamic insurance and reinsurance legal entities;
• operational risk as well as conduct risk, including mis-selling claims and fraud;
• significant events of Sharī‘ah non-compliance;
• potential high-risk factors for contagion; and
• events which may endanger the viability of the insurance group or major legal entities belonging to the insurance group.

25.3.3 Other involved supervisors should request information in relation to the group for a timely assessment of a TU located in its jurisdiction.

25.4 The group-wide supervisor discusses and agrees with other involved supervisors to establish suitable coordination arrangements for cross-border insurance groups operating in its jurisdiction.

25.4.1 Coordination arrangements, including supervisory colleges, are mechanisms to foster cooperation and coordination between involved supervisors with regard to the supervision of insurance groups, as well as to promote common understanding, communication and information exchange.

25.4.2 The group-wide supervisor should initiate discussions with other involved supervisors about suitable coordination arrangements. Involved supervisors should seek a consensus on the most appropriate form of coordination arrangements.

25.5 The group-wide supervisor sets out the coordination arrangements in a written coordination agreement and puts such arrangements in place.

25.5.1 The scope of coordination arrangements will vary and should reflect the circumstances of the particular insurance group and involved supervisors.

25.5.2 A written coordination agreement should cover activities including:
• information flows between involved supervisors;
• communication with the head of the group;
• convening periodic meetings of involved supervisors;
• the conduct of a comprehensive assessment of the group, including the objectives and process used for such an assessment; and
• supervisory cooperation during a crisis.

25.6 The supervisor discusses and agrees with involved supervisors whether to establish a supervisory college for cross-border insurance groups operating in its jurisdiction, and if so, how to structure and operate the supervisory college.

*Establishing a Supervisory College*
25.6.1 The group-wide supervisor, in cooperation and coordination with other involved supervisors, should consider establishing a supervisory college where, for instance:

- the nature, scale and complexity of the cross-border activities or intra-group transactions are significant and associated risks are high;
- group activities or their cessation could have an impact on the overall stability of the *takāful* and/or conventional insurance markets in which the TU operates; and
- the insurance group has significant market share in more than one jurisdiction (see IAIS Application Paper on Supervisory Colleges).

*Structure and Membership of a Supervisory College*

25.6.2 The group-wide supervisor, in cooperation and coordination with the involved supervisors, should carefully consider the structure of the supervisory college (e.g. inclusive, tiered or regional).

25.6.3 A supervisory college is typically comprised of representatives of each of the supervisors responsible for the day-to-day supervision of the insurance legal entities (whether conventional or Islamic), including material or relevant branches, which are part of the group and, as appropriate, any supervisors of other material non-insurance entities.

25.6.4 Clear criteria should be established for defining the basis of membership in the supervisory college. Issues which should be considered in establishing these criteria include:

- the relative size and materiality of the insurance legal entity (whether conventional or Islamic) relative to the insurance group as a whole;
- the relative size or materiality of the insurance legal entity relative to its local market; and
- the level of risk in a particular insurance legal entity.

25.6.5 The structure of and membership in the supervisory college should be reviewed on a regular basis to reflect changing circumstances in the insurance group.

*Coordination Agreement for a Supervisory College*

25.6.6 The purpose of a supervisory college coordination agreement is to establish a framework for the operations of a supervisory college. The agreement is not legally binding and does not create enforceable obligations from one supervisor to another. However, jurisdictions may be subject to an obligation to establish such an agreement.

25.6.7 While recognising the need to allow for flexibility in the operation of a supervisory college, matters covered by the coordination agreement generally should include:

- membership of the supervisory college – including the approach to participation of members in the college;
• the process for appointing a supervisor to chair the college (typically, but not necessarily, the group-wide supervisor);
• roles and functions of the supervisory college and of the members of the supervisory college, including expectations of the chair;
• frequency and locations of meetings (meetings should take place by telephone conference call or other means where an in-person meeting is not practical); and
• scope of the activities of the supervisory college, including ongoing information exchange.

25.6.8 The coordination agreement should include information exchange and confidentiality for both conventional insurance and takāful.

25.6.9 Members of a supervisory college who are not signatories to the IAIS MMOU should enter into a similar long-term agreement covering information exchange and confidentiality, which could be included in the college coordination agreement.

**Functions and Activities of a Supervisory College**

25.6.10 The group-wide supervisor, in cooperation and coordination with the other involved supervisors, should establish the appropriate ongoing functions of the supervisory college and clearly allocate those functions among the involved supervisors to avoid unnecessary duplication of supervisory tasks and to ensure no gaps exist in the supervision of the group.

25.6.11 In establishing the functions of a supervisory college, the key activities which should be considered include:
• providing access for involved supervisors to information and knowledge about the group and the environment in which it operates through information sharing;
• assessing group-wide risk exposures, financial position and regulatory capital adequacy and the group-wide corporate governance framework, including risk management, internal control and intra-group relationships such as intra-group transactions and exposures;
• understanding the material operations, solvency and liquidity needs of the material legal entities within the group;
• coordinating supervisory activities such as joint off-site monitoring or on-site inspections or review of one or more entities within the group or of a particular aspect of the group’s functions such as internal audit, actuarial, risk management or compliance;
• coordinating appropriate actions to ensure that the group and relevant entities within the group mitigate identified risks;
• forming special focus teams to evaluate areas of particular concern or importance to the involved supervisors, or to bring together the requisite expertise to examine an aspect of the group’s operations;
• providing a forum for involved supervisors to interact with group-wide senior management in order to, for example, inform senior
management of an identified issue at a TU or conventional insurance legal entity that affects the whole insurance group; and
• regularly assessing the effectiveness of the supervisory college in fulfilling its agreed role and functions. The assessment should be organised by the group-wide supervisor and take into account input from the other involved supervisors and, as appropriate, legal entities.

25.6.12 Where the insurance group is predominantly engaged in takāful business, or such business is material to the group, the potential activities of the college also include group-wide consideration of risks or governance issues specific to takāful (e.g. Sharī‘ah non-compliance risk and Sharī‘ah governance). Even where that is not the case, involved supervisors responsible for supervising takāful legal entities should alert other members of the supervisory college where group-level or intra-group policies, transactions, activities or relationships have the capacity to affect such risks or governance issues at the level of the takāful legal entities, and seek cooperation in examining the matter.

25.6.13 Aside from group-wide issues, supervisory colleges may also focus on issues specific to TUs or conventional insurance legal entities within the insurance group.

**Supervisory Cooperation in Planning for Crisis Management**

25.7 The group-wide supervisor coordinates crisis management preparations with other involved supervisors and relevant authorities.

**Objectives of Crisis Preparation Planning**

25.7.1 The main objectives of supervisory crisis management planning should be:
• to protect takāful participants and conventional insurance policyholders; and
• to contribute to domestic or international financial stability to avoid a potential adverse impact on the real economy.

25.7.2 In planning for crisis management the group-wide supervisor and other involved supervisors should seek to:
• promote private-sector solutions such as portfolio transfers and run-offs;
• minimise the need to use public support to protect takāful participants and conventional insurance policyholders;
• minimise disruptions to the efficient operation of the takāful and conventional insurance sector across jurisdictions; and
• achieve an orderly supervisory response.

**Process for Crisis Management Planning**
25.7.3 Supervisory actions in planning for crisis management should seek to secure early communication between involved supervisors and relevant authorities in order to maximise time for coordination and cooperation.

25.7.4 The group-wide supervisor should meet regularly with the other involved supervisors and relevant authorities to share and evaluate information relating to the insurance group and to analyse and assess specific issues (including whether there are systemic implications). These meetings may be held in conjunction with the supervisory college meetings or separately if no supervisory college is in place.

25.7.5 Supervisors should remain aware of potential contagion channels, conflicts of interest and possible barriers to coordinated action in a crisis situation within a specific cross-border insurance group (such as legally required transparency rules in the case of publicly listed companies or particular legislative requirements across jurisdictions).

25.7.6 Effective crisis management should ensure that preparations for and management of a cross-border crisis – including policy measures, crisis response decisions and matters of external communication – are coordinated, timely and consistent. Supervisors and other relevant authorities (e.g. ministries of finance, central banks, other financial sector supervisors, and takāful participant or conventional insurance PPSs) should exchange information to facilitate effective crisis management.

25.7.7 The group-wide supervisor should share with the other involved supervisors and relevant authorities information relevant to crisis management, including:

- group structure (focusing on legal, financial and operational intra-group dependencies, which may not always be available to the other authorities);
- interlinkages between the insurance group and the financial system in each jurisdiction where it operates; and
- potential impediments to a coordinated solution to a crisis.

25.7.8 A supervisory college should plan in advance the process for cooperation and coordination during crisis situations in order to benefit from well-established information and cooperation channels and procedures should a crisis occur. The channels for communication with the head of the group, as well as other parts of the group, should be clearly established in case a crisis emerges. The group-wide supervisor should establish close communication channels with the group board and senior management as well as significant owners.

Supervisory Cooperation During a Crisis

25.8 The supervisor:

- informs the involved supervisors as soon as it becomes aware of a crisis;
• cooperates and coordinates with the involved supervisors and relevant authorities to analyse and assess the crisis situation and its implications to reach a common understanding of the situation; and
• identifies coordinated, timely and effective solutions to a crisis situation.

25.8.1 The group-wide supervisor should coordinate the gathering and analysis of information, as well as coordinate supervisory activities to respond to the crisis.

25.8.2 Such analysis should include:
• implications for takāful participant and conventional insurance policyholder protection in each relevant jurisdiction;
• whether the crisis is of systemic relevance and, if so, the identification of possible sources of systemic risk; and
• processes through which involved supervisors and relevant authorities can respond in a coordinated way.

25.8.3 Such cooperation and coordination takes account of the impact of the crisis on takāful participants and conventional insurance policyholders, financial systems and real economies of all relevant jurisdictions, drawing on information, arrangements and crisis management plans developed beforehand.

25.9 The group-wide supervisor coordinates with other involved supervisors and relevant authorities on public communication and communication with the insurance group during the crisis.

25.9.1 The group-wide supervisor and other involved supervisors, where practicable, share their plans for public communication among themselves and with other authorities to ensure that communication is handled in a coordinated and timely way.

25.9.2 The group-wide supervisor considers when, and to what extent, to communicate with the insurance group and the TUs and conventional insurance legal entities that are part of the group, through their respective takāful and conventional insurance legal entity supervisors.

TCP 26: WINDOW OPERATIONS

The supervisor applies to window operations requirements that are no more favourable than those applicable to TUs having their head office in the same jurisdiction.

Introductory Guidance

26.0.1 Some jurisdictions may permit the provision of takāful services by conventional insurance legal entities. Where window operations are practised, the operator holds out to takāful participants or potential takāful
participants that the operations are conducted on a Sharīʻah-compliant basis as to the contracts concerned and the operations (e.g. the investment of funds). The branch, unit or department of the legal entity providing the takāful services is referred to as the “window”, and the legal entity itself as the “host” conventional insurer. A window may be compared and contrasted with what can be described as a “full-fledged” TU – that is, an undertaking conducting only takāful activities.

26.0.2 A window operation may be managed by a separate legal entity, appointed by the host insurer and undertaking the operational role of TO with respect to the window under delegated authority.

26.0.3 The provision of both Islamic and conventional insurance services within the same legal entity raises issues of Sharīʻah compliance, with attendant risks from both a prudential and a conduct perspective. Where windows are permitted to operate, the two types of operation (Islamic and conventional) are operationally and financially separated, under legislation or by means of constitutional and contractual arrangement of the legal entity concerned, such that the funds attributable to takāful participants are not mingled with funds of the host.

26.0.4 The approach of this TCP is to require supervisors to apply to a window, in a proportionate manner, the supervisory tools that they apply to supervisory review of full-fledged TUs. Supervisors of windows should satisfy themselves that conventional insurers offering windows have internal systems, procedures and controls appropriate to their window operations.

26.1 Legislation or supervisory policy determines, with appropriate definitions, what forms of takāful window are permitted to operate in the jurisdiction.

26.1.1 Not all jurisdictions may permit the operation of windows. Where a jurisdiction requires takāful to be undertaken only by full-fledged TUs, this is made clear in legislation.

26.1.2 Where windows are not prohibited, if legislation does not make provision for forms of windows, the supervisor considers and publishes its approach to permitting the operation of windows.

26.1.3 Considerations for the supervisor in determining its approach could include, without limitation, the types of takāful that may be written within windows, the size that a window may attain (both absolutely and relatively to the size of the host, and how that would be measured) and the legal status of the host (e.g. whether it is a mutual or proprietary insurer, or whether it is a domestic undertaking or a branch of a foreign undertaking).
26.1.4 If legislation or supervisory policy requires the conversion of a window to a full-fledged TU, the point at which such conversion may be required (e.g. based on size, or years of operation) and the process for conversion under applicable laws are made clear.

**Licensing**

**26.2 The operation of a takāful window by a host conventional insurer is subject to prior supervisory approval.**

26.2.1 Legislation may require that a host conventional insurer is separately licensed for its takāful window operations, in which case legislation sets out the requirement and conditions for licensing, which should be proportionate to those required for licensing of full-fledged TUs.

26.2.2 In any case, even where legislation does not provide for separate licensing for windows (where the host is itself already licensed for insurance activity in the jurisdiction), supervisory approval is required before a host may hold itself out as providing takāful services. The supervisor makes public the criteria by which it will assess proposed applications for approval for operation of a window. Such criteria should be proportionate to those required for licensing of full-fledged TUs.

26.2.3 A licence, or supervisory approval, for a window operation is granted only following due consideration of adequate documentation, including a business plan setting out the proposed structure and operations of the window and demonstrating that the proposed window has:

- effective and transparent segregation of funds and operations from those of the host;
- initial funding within the window to demonstrate compliance with requirements for window capital adequacy and liquidity;
- effective policies and procedures for risk management at the level of the window;
- effective policies and procedures for Shari'ah governance of window operations; and
- adequate resources of all types, both financial and non-financial (e.g. appropriately skilled personnel), to enable ongoing compliance with requirements applicable to the window.

26.2.4 The supervisor considers the potential impact on the host of the establishment of a window, before permitting the establishment of a window. Such considerations could, for example, include:

- the impact on its liquidity and capital adequacy of placing funds into a window;
- the knowledge and experience of the board and senior management in relation to takāful; and
- the arrangements made by the board and senior management of the host to supervise the operations of the window.
Effective Segregation of Funds

26.3 The supervisor requires the host to maintain effective segregation of funds attributable to the window from other funds of the host.

26.3.1 The financial operations of the window are ring-fenced from those of the host, such that assets, liabilities, income and expenditure relating to the window are separately attributed to the window, so that assets of the window are not mingled with other assets of the host.

26.3.2 Flows of funds from the window to the host are limited to those permitted by the constitutional arrangements of the window. Funds attributable to takāful participants are not transferred to the host.

26.3.3 The supervisor considers the adequacy of the legal entity’s arrangements, systems and controls for ensuring effective segregation and correct attribution of assets and liabilities, income and expenses, between the host and the window, and attribution to separate funds within the window (in cases where that is relevant – for example, where a window maintains separate PRF(s) and/or PIF(s) or a separate fund for monies attributable to the host but not yet paid over).

Shari‘ah Governance

26.4 The supervisor requires the operations of a window to be subject to effective Shari‘ah governance.

26.4.1 The supervisor requires a window to be subject to Shari‘ah governance arrangements comparable to those that apply to the TO for a full-fledged TU.

26.4.2 Additional guidance on supervisory expectations is contained in TCP 8: Shari‘ah Governance, which applies mutatis mutandis to windows.

Capital Adequacy

26.5 The supervisor applies capital adequacy requirements at the level of the window, determining the funds that may be taken into account for window capital adequacy purposes, the level of capital required to absorb unforeseen losses and the approach to supervisory intervention.

26.5.1 The supervisor’s approach to a window reflects its best understanding of how the window will be treated on insolvency, including the contractual rights of the window’s takāful participants, according to applicable law.
The supervisor determines and understands the manner in which capital and liquidity are made available to the window, and how losses generated by the window will eventually be absorbed.

The supervisor applies capital adequacy requirements comparable to those that apply for a full-fledged TU, including:
- valuation requirements for assets and liabilities of the window, including technical provisions;
- a total balance sheet approach to capital adequacy at the level of the window;
- definition of resources eligible as capital, based on ability to absorb losses;
- a risk-based capital requirement, supported by own risk and solvency assessment;
- trigger levels for supervisory intervention; and
- powers for supervisory intervention.

In assessing eligibility of resources as capital, the supervisor considers whether funds advanced to the window from the host are capable of absorbing losses within the window. In considering this point, the supervisor considers the terms on which the funds are advanced, and the limitations on the ability of the host to require the window to repay the funds. Funds advanced that are not capable of absorbing losses within the window are treated as restricted in eligibility.

The supervisor may permit a window to take into account assets that the host is committed to advance. Where this is permitted, the supervisor assesses whether the commitment has the necessary qualitative features to justify recognising the funds in question as eligible for capital adequacy purposes within the window. Relevant considerations in this assessment include:
- any limitations on the ability of the window to call on the funds;
- whether the host is able and willing to satisfy an immediate call (e.g. if the host would experience capital strain by satisfying the call, or if the host is a foreign insurer that might be subject to restrictions on capital transfers);
- whether the commitment is collateralised by earmarked assets;
- whether the funds, once advanced, are capable of absorbing losses within the window;
- any time limit on the commitment to advance funds; and
- whether the details of the commitment have been reviewed and approved by those responsible for Sharī'ah governance of the window.

The supervisor considers the impact of the relationship between the host and the window, when determining the extent to which funds of the window may be taken into account in assessing the capital adequacy of the host. Relevant considerations include the segregation of funds between the
Disclosure

26.6 The supervisor requires a window to make appropriate disclosure.

26.6.1 The supervisor requires a window to make disclosures comparable to those that apply to the TO for a full-fledged TU. In addition to guidance on disclosure provided in TCP 19: Conduct of Business and TCP 20: Public Disclosure, the following public disclosure requirements are generally appropriate for a window:

- the financial position and performance of the window on a stand-alone basis, making clear the extent, if any, to which the window is dependent on support from the host (e.g. qard);
- any arrangements for financial support from the host, and any support given in the past and not yet repaid;
- the organisational relationship with the host (e.g. whether the window is established as a division/unit/department or branch of the host, and how it is managed);
- the arrangements for segregation of funds from those of the host, including disclosure of the possible flows of funds that may take place between the window and the host (e.g. profit-sharing portion and wakālah fee); and
- joint transactions (if any) between the window and the host – for example, joint placement of retakāful/conventional reinsurance, or apportionment of expenses incurred in common.
SECTION 3: ASSESSMENT METHODOLOGY

51. The IFSB strongly encourages implementation of the TCPs as a means to ensure that each jurisdiction has a framework for effective supervision of takāful. Assessment of a jurisdiction’s observance of TCPs can facilitate effective implementation by identifying the extent and nature of strengths and weaknesses in a jurisdiction’s supervisory framework – especially those aspects that could affect protection of takāful participants, the fairness, safety and stability of the takāful market, and financial stability more broadly, and customer confidence in the Shari‘ah compliance of market participants and their takāful products.

52. The methodology that should be followed when carrying out an assessment of a jurisdiction’s observance of the TCPs is set out below. Following the methodology should result in greater consistency between assessments, especially assessments of different jurisdictions performed by different assessors. While the results of an assessment may not always be made public, it is still important for their credibility that similar types of assessments are conducted in a broadly uniform manner from jurisdiction to jurisdiction.

Scope of Assessments

53. An assessment may be conducted on a system-wide jurisdictional basis or focus on specific areas. While thematic assessments have a role, the IAIS has designed the ICPs as a comprehensive and holistic framework, with each ICP being integral in the creation of a sound supervisory system. Similarly, the TCPs have been developed as a comprehensive and holistic framework, having regard to the specificities of takāful business to enable the assessment of takāful supervision.

54. Where more than one authority is involved in a jurisdiction’s takāful supervision process, the allocation and interaction of supervisory roles should be clearly described in the assessment. If an assessment is conducted in the context of an individual authority within a jurisdiction, a standard may be not applicable if responsibility (either for its implementation or for its delivery on a day-to-day basis) lies with another authority within that jurisdiction. However, the authority responsible for the observance of that standard should be indicated in the report.

55. The TCPs are written to be equally applicable to both family and general takāful sectors. However, where there are material differences between the family and general takāful sectors, such that it would give rise to different results had they

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63 This is not to say that the results of assessments will be identical. Consistent assessments may arrive at different results – for example, where different takāful models practised involve regulatory risks that are not equally addressed in the jurisdiction or jurisdictions in question.
been assessed separately, the assessor may consider assigning separate levels of observance for each sector accordingly. In such cases, the distinction should be clearly identified and explained in any assessment report.

56. The TCPs are also written to be applicable to all models of Islamic insurance, with modifications according to the specificities of different models. However, if there are material differences in a jurisdiction between the supervisory framework applicable to different models (e.g. between the framework applicable to supervision of business conducted on a wakālah and on a waqf basis), the assessor may consider assigning separate levels of observance for supervision of each model. In such cases, the distinction should be clearly identified and explained in any assessment report.

57. The process of assessing observance of TCPs requires a judgmental weighing of numerous elements. It is important, therefore, that assessors are well qualified with relevant background, professional knowledge and practical experience. Background, knowledge and experience in the conventional insurance sector may be desirable attributes. However, assessors not familiar with supervision of takāful business, the takāful sector, or entities and products that may be unique to the jurisdiction being assessed, could come to incorrect or misleading conclusions.

58. In particular, assessors should possess, or have access to, a knowledge of the Shariʻah principles to which the takāful sector is required to adhere, when assessing observance of TCPs dealing with requirements in the supervisory framework for market participants in that jurisdiction to demonstrate effective Shariʻah governance. Assessors are not called upon to make Shariʻah compliance judgments, but to evaluate aspects of the supervisory framework that mandate and supervise Shariʻah governance. Accordingly, assessors need the ability to understand the approach of the supervisory framework in that jurisdiction to matters of Shariʻah governance and compliance.

Assessment Process

59. When conducting an assessment, assessors need to have access to a range of information and people. The required information may include published information (such as the legislation and administrative policies) as well as non-published information (such as self-assessments performed and operational guidelines used by the supervisor). The supervisor may provide confidential information to the assessors, provided confidentiality is preserved. Information should be provided to and be analysed by the assessors in advance, to the extent possible, to ensure that any on-site visits are efficient and derive the most value. The assessors may need to meet with various individuals and organisations, including the supervisor, third parties to whom the supervisor outsources supervisory activity, other domestic supervisory authorities, relevant government ministries, TOs and takāful industry associations, consumer groups, Shariʻah scholars and consulting firms, actuaries, auditors, and other financial sector participants.
60. Assessments should be based solely on the legislation and supervisory practices that are in place at the time. As a result, it is important to recognise when an assessment is conducted and to record this in the report. Nevertheless, improvements already proposed or scheduled for implementation by the supervisor should be noted in the assessment report by way of additional comments so as to provide recognition for efforts that are important, but not yet fully implemented. Additionally, the assessment should consider whether supervisory practices adequately meet the outcomes provided for in legislation and whether the supervisor enforces compliance. Having legislation without the necessary corresponding supervisory practices is not sufficient to demonstrate full observance.

61. Performing an assessment is not an exact science. Assessors should perform a comprehensive assessment of the degree and effectiveness of implementation for each principle statement and standard, rather than take a checklist approach. The goal of the assessment should not be simply to apply a grade to the level of observance, but to identify areas that need attention in order for the jurisdiction to achieve the outcomes identified in the TCPs.

Assessment of Standards

62. The standards set requirements that are fundamental to the implementation of each principle statement. They also facilitate assessments that are comprehensive, precise and consistent. In making an assessment, each standard under a principle statement has to be considered. As noted in the TCP Introduction, guidance is intended to facilitate the understanding and application of the principle statement and/or standard and does not prescribe any requirements; therefore, it should not be assessed for observance.

63. The standards should be assessed using five categories:

- **Observed**: For a standard to be considered observed, it is necessary that the supervisor has and exercises, when required, the legal authority and supervisory practices to effectively perform the requirements of the standard. Having legislation without supervisory practices to implement a standard is insufficient to be considered observed, except for those standards that are specifically focused on legislation itself and what it contains. For supervisory practices which may lack explicit legal authority, the assessment should be considered as observed if the practice is clearly substantiated by the supervisor and is generally accepted by stakeholders. Having the necessary resources is essential for the supervisor to implement standards effectively.

- **Largely observed**: For a standard to be considered as largely observed, it is necessary that only minor shortcomings exist which do not raise any concerns about the supervisor’s ability and intent to achieve full observance with the standard within a prescribed period of time. The assessment of largely observed can be used when the jurisdiction does
not meet all the criteria, but the overall effectiveness is sufficiently good and no material risks are left unaddressed.

- **Partly observed**: For a standard to be considered partly observed, there are sufficient shortcomings to raise doubts about the supervisor’s ability to achieve observance.
- **Not observed**: For a standard to be considered not observed, there is no substantive progress towards achieving observance.
- **Not applicable**: For a standard to be considered not applicable, the standard does not apply given the structural, legal and institutional features of a jurisdiction.

### Assessment of Principle Statements

**64.** As noted above, the level of observance for each principle statement reflects the assessments of its standards. The principle statements should be assessed using five categories:

- **Observed**: For a principle statement to be considered observed, all the standards must be considered observed (except any standards that are considered not applicable).
- **Largely observed**: For a principle statement to be considered largely observed, it is necessary that only minor shortcomings exist which do not raise any concerns about the supervisor’s ability to achieve full observance with the principle statement.
- **Partly observed**: For a principle statement to be considered partly observed, there are sufficient shortcomings to raise doubts about the supervisor’s ability to achieve observance.
- **Not observed**: For a principle statement to be considered not observed, there is no substantive progress towards achieving observance.
- **Not applicable**: For a principle statement to be considered not applicable, all the standards must be considered not applicable.

### Reporting

**65.** The IFSB does not prescribe a set format or content of reports that result from an assessment. However, it is recommended that an assessment report should:

- be in writing;
- identify the scope and timing of the assessment;
- identify the assessors;
- provide an assessment of observance;
- refer to the information reviewed and meetings conducted, and note when any necessary information was not provided and the impact that this may have had on the accuracy or completeness of the assessment;
- include any formal comments provided by the supervisor in response to the assessment; and
- include prioritised recommendations for improving observance of the TCPs assessed.

**66.** While encouraged, it is the jurisdiction’s discretion whether to publish the results of an assessment. Nevertheless, it is important for the credibility of
assessments that they are conducted in a broadly uniform manner across jurisdictions.

67. Where a supervisor is a member of a supervisory college for an IAIG that includes takāful operations, the supervisor should be mindful that information on the result of an assessment of observance of TCPs may be of relevance for the effective group-wide supervision of the group, and involved supervisors are therefore encouraged to share the results of an assessment within the supervisory college.

Pre-conditions for Effective Takāful Supervision

68. An effective system of takāful supervision requires a number of pre-conditions to be in place, as they can have a direct impact on supervision in practice. An assessment of a jurisdiction’s observance of the principle statements and standards may involve a review of pre-conditions for effective takāful supervision.

69. This section provides a number of categories of pre-conditions and descriptions of how each pre-condition may be reviewed. The pre-conditions include:

• sound and sustainable macroeconomic and financial sector policies;
• a well-developed public infrastructure;
• effective market discipline in financial markets;
• mechanisms for providing an appropriate level of protection; and
• efficient financial markets.

Each pre-condition must be considered in the context of the specificities of takāful.

70. As these pre-conditions are normally outside the control or influence of the supervisor, and because they are beyond the scope of the TCPs, an assessment should not evaluate a jurisdiction’s observance of the pre-conditions. Instead, the objective of a review of pre-conditions is to help inform an assessment of observance of the TCPs because the pre-conditions can directly impact the effectiveness of supervision. Where shortcomings exist, the supervisor should make its government aware of these and their actual or potential repercussions for the achievement of supervisory objectives and seek to mitigate the effects of such shortcomings on the effectiveness of supervision.

71. Any report on a review of pre-conditions should:

• be descriptive and not express an opinion on the adequacy of policies in these areas, other than through reference to analyses and recommendations in existing official documents;
• include an analysis of the linkages between these factors and the resilience of the takāful sector, when relevant;
• give a clear picture of the adequacy of the pre-conditions within the jurisdiction and the interaction of the pre-conditions with the assessment of observance of the TCPs; and
• flag any individual TCPs which are most likely to be affected by any material weakness in the pre-conditions.

Sound and Sustainable Macroeconomic and Financial Sector Policies

72. Sound macroeconomic policies are the foundation of a stable financial system. This is not within the mandate of supervisors, although they will need to react if they perceive that existing policies are undermining the safety and soundness of the financial system. In addition, financial sector supervision needs to be undertaken within a transparent government policy framework aimed at ensuring financial stability, including effective supervision of the takāful and other financial sectors.

73. A review of this pre-condition should include a review of the relevant government financial sector policies, including whether there is a clear and published framework assigning responsibility to different bodies involved in financial stability and supervisory work.

Well-Developed Public Infrastructure

74. A well-developed public infrastructure contains the following elements which, if not adequately provided, can contribute to the weakening of the financial system or frustrate their improvement:

• a system of business laws, including corporate, insolvency, contract, consumer protection and private property laws, which is consistently enforced and provides a mechanism for the fair resolution of disputes;
• an efficient and independent judiciary;
• use of comprehensive and well-defined accounting principles and rules that command wide international acceptance;
• a system of independent audits for companies to ensure that users of financial statements, including TOs, have independent assurance that the accounts provide a true and fair view of the financial position of the company and are prepared according to established accounting principles, with auditors held accountable for their work;
• the availability of skilled, competent, independent and experienced actuaries, accountants and auditors, whose work complies with transparent technical and ethical standards set and enforced by official or professional bodies in line with international standards and is subject to appropriate oversight;
• well-defined rules governing, and adequate supervision of, other financial sectors;
• access to a secure payment and clearing system for the settlement of financial transactions where counterparty risks are controlled; and
• the availability to the supervisor, financial services and public of basic economic, financial and social statistics.

75. A review of the public infrastructure should focus on elements relevant to the takāful sector.
Effective Market Discipline in Financial Markets

76. Effective market discipline depends, in part, on adequate flows of information to market participants, appropriate financial incentives to reward well-managed institutions, and arrangements that ensure investors are not insulated from the consequences of their decisions. Among issues to be addressed are the existence of appropriate corporate governance frameworks and ensuring that accurate, meaningful, transparent and timely information is provided by issuers and borrowers to investors and creditors.

77. A review of the effectiveness of market discipline could cover issues such as:

- the presence of rules on corporate governance;
- transparency and audited financial disclosure;
- appropriate incentive structures for the hiring and removal of managers and board members;
- protection of shareholders’ and other stakeholders’ rights;
- adequate availability of market and consumer information; and
- an effective framework for new entrants, mergers, takeovers, and acquisition of equity interests, including those involving foreign entities.

Mechanisms for Providing an Appropriate Level of Takāful Participant Protection

78. In general, deciding on the appropriate level of takāful participant protection is a policy question to be addressed by each jurisdiction. Protection mechanisms could include, for example, a hierarchy of claims or a takāful participant protection scheme. Provided such mechanisms are transparent and carefully designed to limit moral hazard, they can contribute to public confidence. For issues such as crisis management or the resolution of a TU, the supervisor should have a role to play given its in-depth knowledge of the entities involved.

Efficient Financial Markets

79. Efficient financial markets are important to provide investment and risk management opportunities for TUs. TUs benefit by having access to domestic and global financial markets.

80. A review of whether there are efficient financial markets could cover, for example, the range of instruments and issuers (e.g. is there a spread of public-sector issues of different types) and the spread of available maturities. A review could take note of how liquidity has been affected in markets in periods of stress. A review should focus on relevant issues for the carrying on of takāful business, taking into account the products offered, such as whether annuities or other long-term contracts of takāful are provided.
<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
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<tbody>
<tr>
<td>Alternative risk mitigation</td>
<td>Forms of risk mitigation of takāful liabilities other than retakāful and conventional reinsurance.</td>
</tr>
<tr>
<td>Asset–liability management (ALM)</td>
<td>A TO’s coordination of decisions and actions taken with respect to assets and liabilities through the ongoing process of formulating, implementing, monitoring and revising strategies related to assets and liabilities to achieve the TO’s financial objectives, given the risk appetite and other constraints.</td>
</tr>
<tr>
<td>Back-testing</td>
<td>A process of comparing the predictions from a model with actual experience to determine whether actual results are within the expected range produced by the model over a reasonable period of time.</td>
</tr>
<tr>
<td>Basis risk</td>
<td>The risk that returns on instruments of varying types, credit quality, marketability, liquidity and/or maturity do not move together, thus exposing a TO to market value variation of assets and/or hedges that can be independent of liability values. In respect to retakāful transactions, basis risk is the risk that the actual loss experience of a TU does not move together with the risk shared with an RTU.</td>
</tr>
<tr>
<td>Board of directors (board)</td>
<td>A body of elected or appointed individuals ultimately responsible for the governance and oversight of a TU.</td>
</tr>
<tr>
<td>calibration test</td>
<td>A test to demonstrate that the regulatory capital requirement determined by the internal model satisfies the specified modelling criteria.</td>
</tr>
<tr>
<td>Capital</td>
<td>The financial resources of a TU of different forms and descriptions including equity capital (i.e. paid-up, share, subscribed), economic capital and regulatory capital. Where segregation of funds is practised, the term also includes financial resources of the fund (or of an arrangement such as an Islamic window).</td>
</tr>
<tr>
<td>Capital add-on</td>
<td>An additional capital requirement imposed by the supervisor to address, for example, any identified weaknesses in an internal model or other more tailored approach as a condition on its use or in the context of a review of the ongoing validity of an internal model for regulatory capital purposes.</td>
</tr>
<tr>
<td>Capital adequacy</td>
<td>The adequacy of capital resources relative to regulatory capital requirements.</td>
</tr>
<tr>
<td>Capital resources</td>
<td>Financial resources that are capable of absorbing losses.</td>
</tr>
<tr>
<td>Claims incurred</td>
<td>A TU’s total liability arising from takāful events related to an accounting period either on an accident-year basis or on an underwriting-year basis.</td>
</tr>
<tr>
<td>Claims provision</td>
<td>Amount set aside on the balance sheet of a TU to meet the total estimated ultimate cost to settle all claims arising from events which have occurred up to the end of the reporting period, whether reported or not, less amounts already paid in respect of such claims.</td>
</tr>
<tr>
<td>Collateral</td>
<td>Assets held as security in support of a promise to pay a debt or perform other obligations under a contract.</td>
</tr>
<tr>
<td>Combined ratio</td>
<td>The sum of the loss ratio (claims ratio) and the expense ratio.</td>
</tr>
<tr>
<td>Term</td>
<td>Description</td>
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<tr>
<td>Concentration risk</td>
<td>The risk of adverse changes in the value of capital resources due to the lack of diversification in the risk exposures.</td>
</tr>
<tr>
<td>Conduct risk</td>
<td>The risk of financial loss or other adverse consequences that arises from TOs and/or intermediaries conducting their business in a way that treats customers unfairly or results in harm to customers.</td>
</tr>
<tr>
<td>Consumers</td>
<td>The universe of actual and potential customers for takāful products.</td>
</tr>
<tr>
<td>Contagion risk</td>
<td>The risk that an event, whether internal or external, has a negative impact on one legal entity or part of a group and spreads to other legal entities or parts of the group.</td>
</tr>
<tr>
<td>Contingency plan</td>
<td>A plan developed by a TO that describes in advance the necessary actions and resources to limit business disruption and losses resulting from adverse financial or operational events.</td>
</tr>
<tr>
<td>Continuum-based approach</td>
<td>Involves the setting of characteristics against which individual capital elements can be assessed as to their quality; instruments are ranked against other instruments to determine whether they are included as capital resources. Where a categorisation approach is used, the criteria will be used to determine the category of capital resources in which a capital element is included.</td>
</tr>
<tr>
<td>Control function</td>
<td>Function (whether in the form of a person, unit or department) that has a responsibility in a TU to provide objective assessment, reporting and/or assurance; this includes the risk management, compliance, actuarial and internal audit functions and equivalent functions addressing Shari'ah compliance.</td>
</tr>
<tr>
<td>Control level</td>
<td>A threshold solvency level that requires intervention of the supervisor or imposes certain restrictions on the TU if the actual solvency level falls below this level. Solvency levels may apply at the level of a segregated fund, a legal entity or a group.</td>
</tr>
<tr>
<td>Conventional insurance legal entity</td>
<td>A legal entity, including its branches, that is licensed to conduct conventional insurance, regulated and subject to supervision.</td>
</tr>
<tr>
<td>Corporate culture</td>
<td>The set of norms, values, attitudes and behaviours of a TO that characterises the way in which the TO conducts its activities.</td>
</tr>
<tr>
<td>Corporate governance framework</td>
<td>The strategies, policies and processes through which a TO is managed and controlled.</td>
</tr>
<tr>
<td>Counterparty risk</td>
<td>The risk that a counterparty does not comply with its contractual obligations. This includes components of credit risk.</td>
</tr>
<tr>
<td>Credit default risk</td>
<td>The risk that a TU will not receive the cash or assets to which it is entitled because a party with which the TU has a bilateral contract defaults on one or more obligations.</td>
</tr>
<tr>
<td>Credit rating</td>
<td>A category or classification that is assigned to an issuer of debt or a debt instrument based on an evaluation of its creditworthiness.</td>
</tr>
<tr>
<td>Credit rating agency</td>
<td>An entity that evaluates and assigns credit ratings to an issuer of debt or a debt instrument.</td>
</tr>
<tr>
<td>Credit risk</td>
<td>The risk of adverse changes in the value of capital resources due to unexpected changes in the actual default as well as in the deterioration of an obligor's creditworthiness short of default, including migration risk, and spread risk due to defaults.</td>
</tr>
<tr>
<td>Current estimate</td>
<td>The probability weighted average of the range of present values of the cash flows associated with fulfilling a TU’s obligations under a takāful contract. For some types of takāful liability, it may be considered that the projection of future cash flows is unrealistic, and</td>
</tr>
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therefore presents a spurious level of accuracy in the estimate. For such examples the alternative estimate should be arrived at using similar considerations regarding the obligations of the contract as for those examples where projected cash flows are realistic.

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
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<tbody>
<tr>
<td>Customer</td>
<td><em>Takāful</em> participant or prospective <em>takāful</em> participant with whom a TO or <em>takāful</em> intermediary interacts, and includes, where relevant, other beneficiaries and claimants with a legitimate interest in the policy.</td>
</tr>
<tr>
<td>Deficiency</td>
<td>The situation where the liabilities of a fund exceed its assets, so that the fund has a debit balance.</td>
</tr>
<tr>
<td>Deficit</td>
<td>The situation where claims and other expenses exceed <em>takāful</em> contributions for a financial period, whether or not a deficiency arises.</td>
</tr>
<tr>
<td>Derivative</td>
<td>A financial instrument whose value depends on (or is derived from) other assets, liabilities or indexes.</td>
</tr>
<tr>
<td>Deterministic scenario</td>
<td>An event, or a change in conditions, with a set probability in which the underlying assumptions are fixed.</td>
</tr>
<tr>
<td>Double gearing</td>
<td>Used to describe a situation where the same capital is used simultaneously as a buffer against risk in two or more legal entities of a group or, where segregation of funds is practised, two or more funds of a TU.</td>
</tr>
<tr>
<td>Duration</td>
<td>A measure that could be used to estimate the sensitivity of the value of an asset or a liability to changes in discount rates.</td>
</tr>
<tr>
<td>Economic capital</td>
<td>The capital needed by a TU to satisfy its risk appetite and support its business plans and which is determined from an economic assessment of the TU's risks, the relationship between them and the risk mitigation in place.</td>
</tr>
<tr>
<td>Effect horizon</td>
<td>The period over which the shock that is applied to a risk will impact the TU.</td>
</tr>
<tr>
<td>Enterprise risk</td>
<td>The strategies, policies and processes of identifying, assessing, measuring, monitoring, controlling and mitigating risks in respect of the TO's enterprise as a whole.</td>
</tr>
<tr>
<td>management (ERM)</td>
<td></td>
</tr>
<tr>
<td>Excess capital</td>
<td>See “Solvency margin”.</td>
</tr>
<tr>
<td><em>Fatwā</em> (plural <em>fatāwa</em>)</td>
<td>A juristic opinion given by a <em>Sharīʻah</em> board or other authoritative body or person, on any matter pertinent to <em>Sharīʻah</em> issues, based on the appropriate methodology.</td>
</tr>
<tr>
<td>Financial conglomerate</td>
<td>Two or more legal entities, at least one of which is a <em>takāful</em> or conventional insurance legal entity and one a regulated legal entity in the Islamic or conventional securities or banking sectors, where one has control over one or more <em>takāful</em> or conventional insurance legal entities or one or more regulated legal entities in the Islamic or conventional securities or banking sectors and possibly other non-regulated legal entities, whose exclusive or predominant activities consist of providing significant services in at least two different Islamic or conventional financial sectors (banking, securities, insurance).</td>
</tr>
<tr>
<td>General purpose</td>
<td>Financial reports prepared according to generally accepted accounting principles within the relevant jurisdiction to meet the common financial information needs of a wide range of users, including <em>takāful</em> participants and investors.</td>
</tr>
<tr>
<td>financial reports</td>
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<tr>
<td>Term</td>
<td>Definition</td>
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</tr>
<tr>
<td>Going concern basis</td>
<td>An approach for considering a TU’s financial situation assuming it will continue to operate and that future business will be written.</td>
</tr>
<tr>
<td>Going concern capital</td>
<td>Capital which achieves both the objectives of reducing the probability of insolvency by absorbing losses on a going concern basis, or in run-off, and of reducing the loss to takāful participants in the event of insolvency or winding-up.</td>
</tr>
<tr>
<td>Group risk</td>
<td>The risk that the financial condition of a group or a legal entity within the group may be adversely affected by a group-wide event, an event in a legal entity, or an event external to the group. Such an event may either be financial or non-financial (such as a restructuring).</td>
</tr>
<tr>
<td>Group-wide supervisor</td>
<td>The supervisor(s) responsible for effective and coordinated supervision of an insurance group, including coordinating with other relevant supervisors in undertaking the supervision of an insurance group on a group-wide basis, as a supplement to TU or insurance legal entity supervision.</td>
</tr>
<tr>
<td>Head of the insurance group</td>
<td>The legal entity that controls the insurance group.</td>
</tr>
<tr>
<td>Hedging</td>
<td>Actions taken to offset the impact of risks materialising.</td>
</tr>
<tr>
<td>Home jurisdiction</td>
<td>The jurisdiction in which either:</td>
</tr>
<tr>
<td></td>
<td>• a TU or insurance legal entity is incorporated, or its head office or principal place of management is located; or</td>
</tr>
<tr>
<td></td>
<td>• the head of an insurance group is incorporated, or its head office or principal place of management is located.</td>
</tr>
<tr>
<td>Home supervisor</td>
<td>The supervisor of the home jurisdiction.</td>
</tr>
<tr>
<td>Host jurisdiction</td>
<td>Any jurisdiction other than the home jurisdiction in which the TU or insurance legal entity has operations or the insurance group has operations.</td>
</tr>
<tr>
<td>Host supervisor</td>
<td>Any supervisor from a host jurisdiction.</td>
</tr>
<tr>
<td>ICP materials</td>
<td>The Introduction and Assessment Methodology, the ICPs and the IAIS Glossary, as adopted by the IAIS.</td>
</tr>
<tr>
<td>Insurance group</td>
<td>Two or more legal entities, at least one of which is a TU or conventional insurance legal entity, where one has control over one or more TUs or conventional insurance legal entities and possibly other non-regulated legal entities, and whose primary business is takāful or insurance. “Insurance group” includes insurance-led financial conglomerates.</td>
</tr>
<tr>
<td>Insurance risk</td>
<td>The risk of adverse change in the value of capital resources due to unexpected changes in the assumptions of pricing or reserving such as severity, frequency, trend, volatility or level of occurrence rates.</td>
</tr>
<tr>
<td>Insurer</td>
<td>Conventional insurance legal entity or insurance group.</td>
</tr>
<tr>
<td>Internal controls</td>
<td>A set of processes, policies and activities governing a TO’s organisational and operational structure, including reporting and the control functions.</td>
</tr>
<tr>
<td>Internal model</td>
<td>A model which a TO either develops internally or, in the case of an externally developed model, customises for its own use in the calculation of economic and regulatory capital, measurement of risks, or valuation of balance sheet items.</td>
</tr>
<tr>
<td>Investment risk</td>
<td>The risk directly or indirectly associated with or arising from a TU’s investment activities.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
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</tr>
<tr>
<td>Involved supervisors</td>
<td>Supervisors engaged in the supervision of an insurance group.</td>
</tr>
<tr>
<td>Key persons in control functions</td>
<td>Persons responsible for heading control functions.</td>
</tr>
<tr>
<td>Legal risk</td>
<td>The risk that a TU may be adversely affected due to legal uncertainty that can arise from unenforceable contracts, change in laws or regulations, or failure to properly comply with legislation.</td>
</tr>
<tr>
<td>Leverage</td>
<td>The ability to influence a system in a way that multiplies the outcome of one’s efforts without a corresponding increase in the consumption of resources. This implies that leverage is the advantageous condition of having a relatively small amount of cost, which could yield a relatively high level of returns. “Financial leverage” refers to the use of borrowed money to increase the production volume and thus the net earnings. It is measured as the ratio of total debt to total assets. The greater the amount of debt, the greater the financial leverage.</td>
</tr>
<tr>
<td>Licence</td>
<td>The formal authority given to conduct takāful activities or takāful intermediation, within a jurisdiction, under the applicable legislation.</td>
</tr>
<tr>
<td>Liquidation</td>
<td>A process to terminate operations and corporate existence of the entity through which the remaining assets of the TU or fund will be distributed to its creditors and owners according to the liquidation claims hierarchy. Branches and funds may also be capable of being put into liquidation, separately from the TU they belong to.</td>
</tr>
<tr>
<td>Liquidity risk</td>
<td>The risk that a TU is unable to realise its investments and other assets in a timely manner in order to meet its financial obligations, including collateral needs, as they fall due.</td>
</tr>
<tr>
<td>Loss ratio (claims ratio)</td>
<td>The ratio of claims incurred to earned premiums that provides an indication of how well the pricing of a TO matches the risks taken in the takāful contracts (may be reported either gross or net of retakāful).</td>
</tr>
<tr>
<td>Macroeconomic exposure</td>
<td>Exposure of a TU or the takāful sector as a whole to macroeconomic risk factors resulting in their financial position being highly correlated with the broader financial markets and/or real economy and with each other.</td>
</tr>
<tr>
<td>Margin over current estimate (MOCE)</td>
<td>A margin that exceeds the current estimate in valuation of technical provisions to cover the inherent uncertainty of those obligations.</td>
</tr>
<tr>
<td>Market-consistent valuation</td>
<td>An economic valuation of a TU’s assets and liabilities that is consistent with either the assessment of their risk and value by market participants (“mark-to-market” valuation) or, in the absence of a direct market evaluation, the valuation principles, methodologies and risk parameters that market participants would expect to be used (“mark-to-model” valuation).</td>
</tr>
<tr>
<td>Market risk</td>
<td>The risk of adverse change in the value of capital resources due to unexpected changes in the level or volatility of market prices of assets and liabilities.</td>
</tr>
<tr>
<td>Minimum capital requirement (MCR)</td>
<td>In the context of a legal entity’s or of a fund’s capital adequacy assessment, the level of solvency at which, if breached, the supervisor would invoke its strongest actions, in the absence of appropriate corrective action by the TO.</td>
</tr>
</tbody>
</table>
Mismatching risk
The risk that the future cash flows generated by assets do not match the cash flow demands in magnitude or timing of the corresponding liabilities in a suitable manner.

*Muḍārabah*
A partnership contract between the capital provider (*rabb al-māl*) and an entrepreneur (*muḍārib*) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to misconduct, negligence or breach of contracted terms.

Multiple gearing
Using the same capital simultaneously as a buffer against risk in two or more legal entities of a group. This includes double gearing.

Operating ratio
The combined ratio adjusted by the addition of allocated investment return to earned *takāful* contributions.

Operational risk
The risk arising from inadequate or failed internal processes or systems, behaviour of personnel, or from external events. Operational risk includes legal risk, *Shari‘ah* non-compliance risk, fiduciary risk and the portion of custody risk that impacts TUs, but excludes strategic and reputational risk.

Outsourcing
An arrangement between a TO and a service provider, whether internal within a group or external, for the latter to perform a process, service or activity which would otherwise be performed by the TO itself.

Political risk
The risk a TU faces as a result of political changes or instability in a country.

Portfolio transfer
Transfer of one or more policies together with, when relevant, the assets backing those liabilities.

Participants’ investment fund (PIF)
A fund to which a portion of contributions paid by *takāful* participants is allocated for the purpose of investment and/or savings.

Participants’ risk fund (PRF)
A fund to which a portion of contributions paid by *takāful* participants is allocated for the purpose of meeting claims by *takāful* participants on the basis of mutual assistance or protection.

*Qard*
The payment of money to someone who will benefit from it provided that its equivalent is repaid. The repayment of the money is due at any point in time, even if it is deferred.

Recovery plan
A plan developed by a TO that identifies in advance options to restore the financial condition and viability of the TU under severe stress.

Regulatory capital
Excess of assets over liabilities, evaluated in accordance with regulation in a particular jurisdiction.

Regulatory capital requirements
Financial requirements that are set as part of the solvency regime and relate to the determination of amounts of capital that a TU or fund must have in addition to its technical provisions and other liabilities.

Reinsurer
A conventional insurer that assumes the risks of a ceding conventional insurer or TU in exchange for a premium.
<table>
<thead>
<tr>
<th>Term</th>
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<tr>
<td>Reputational risk</td>
<td>The risk that potential negative publicity regarding a TO’s business practices will cause a decline in the customer base or brand value, costly litigation or revenue reductions.</td>
</tr>
<tr>
<td>Resolution</td>
<td>Actions taken by a resolution authority towards a TU or fund that is no longer viable, or is likely to be no longer viable, and has no reasonable prospect of returning to viability.</td>
</tr>
<tr>
<td>Resolution authority</td>
<td>A person that is authorised by law to exercise resolution powers over TUs.</td>
</tr>
<tr>
<td>Resolution plan</td>
<td>A plan that identifies in advance options for resolving all or part(s) of a TU to maximise the likelihood of an orderly resolution, the development of which is led by the supervisor and/or resolution authority in consultation with the TO in advance of any circumstances warranting resolution.</td>
</tr>
<tr>
<td>Retakāful</td>
<td>An arrangement whereby a <em>takāful</em> undertaking cedes a portion of its risks on the basis of treaty or facultative <em>retakāful</em> as a representative of participants under a <em>takāful</em> contract, whereby it would contribute a portion of the contribution as <em>tabarru'</em> into a common fund to cover against specified loss or damage.</td>
</tr>
<tr>
<td>Retakāful operator</td>
<td>Any establishment or entity that manages a <em>retakāful</em> business, usually, though not necessarily, a part of the legal entity in which the ceding participants’ interests are held.</td>
</tr>
<tr>
<td>Retakāful risk fund</td>
<td>A fund to which a proportion of contributions paid by cedants to <em>retakāful</em> operators is allocated for the purpose of meeting claims by cedants on the basis of mutual assistance or protection.</td>
</tr>
<tr>
<td>Retakāful undertaking</td>
<td>An undertaking operating under the principles of <em>takāful</em> but in which the <em>takāful</em> participants are themselves <em>takāful</em> undertakings and the risks shared are those of the original <em>takāful</em> undertakings’ participants.</td>
</tr>
<tr>
<td>Retrocession</td>
<td>Conventional reinsurance ceded by conventional reinsurers or RTUs to assuming conventional reinsurers in exchange for a premium.</td>
</tr>
<tr>
<td>Risk appetite</td>
<td>The aggregate level and types of risk a TO is willing for the TU to assume, within its risk capacity, to achieve its strategic objectives and business plan.</td>
</tr>
<tr>
<td>Risk capacity</td>
<td>The maximum level of risk a TU can assume given its current level of resources taking into account regulatory capital requirements, economic capital, liquidity needs, the operational environment (e.g. technical infrastructure, risk management capabilities, expertise) and obligations to policyholders, shareholders and other stakeholders.</td>
</tr>
<tr>
<td>Risk culture</td>
<td>The set of norms, values, attitudes and behaviours of a TO that characterises the way in which the TO conducts its activities related to risk awareness, risk taking, and risk management and controls.</td>
</tr>
<tr>
<td>Risk limit</td>
<td>Quantitative measure based on a TO’s risk appetite which gives clear guidance on the level of risk to which the TO is prepared for the TU to be exposed and is set and applied in aggregate or individual units such as risk categories or business lines.</td>
</tr>
<tr>
<td>Risk limits structure</td>
<td>The aggregate set of a TO’s self-imposed limits on its material risks and their interdependencies, as part of its ERM framework for the TU.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
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</tr>
<tr>
<td>Risk management</td>
<td>The process through which risks are managed allowing all risks of a TU to be identified, assessed, monitored, mitigated (as needed) and reported on a timely and comprehensive basis.</td>
</tr>
<tr>
<td>Risk profile</td>
<td>Point-in-time assessment of the TU’s gross and, as appropriate, net risk exposures aggregated within and across each relevant risk category based on forward-looking assumptions.</td>
</tr>
<tr>
<td>Risk tolerance</td>
<td>The term &quot;risk tolerance&quot; is used to include the active retention of risk that is appropriate for a TU in the context of its strategy, financial strength, and the nature, scale and complexity of its business and risks. Risk tolerance is typically a percentage of the absolute risk-bearing capacity for a TU.</td>
</tr>
<tr>
<td>Run-off</td>
<td>A process under which a TU ceases to write new business and administers existing contractual obligations. A “solvent run-off” is the process initiated for a TU who is still able to pay debts to its creditors when the debts fall due. An “insolvent run-off” is the process initiated for a TU who is no longer able to pay debts to its creditors when the debts fall due. Run-off may also apply at the level of a single takāful fund.</td>
</tr>
<tr>
<td>Scenario analysis</td>
<td>A method of assessment that considers the impact of a combination of circumstances to reflect historical or other scenarios which are analysed in light of current conditions. Such analysis may be conducted deterministically or stochastically.</td>
</tr>
<tr>
<td>Senior management</td>
<td>The individuals or body responsible for managing a TO on a day-to-day basis in accordance with strategies, policies and procedures set out by the board.</td>
</tr>
<tr>
<td>Shareholders’ fund</td>
<td>A fund that represents the assets and liabilities of a takāful or retakāful undertaking that are not attributable to participants.</td>
</tr>
<tr>
<td>Sharī‘ah</td>
<td>The practical divine law deduced from its legitimate sources: the Qur’ān, Sunnah, consensus (ijmā’), analogy (qiyās) and other approved sources of the Sharī‘ah.</td>
</tr>
<tr>
<td>Sharī‘ah advisory firm</td>
<td>An entity that provides professional Sharī‘ah advisory services, which may include Sharī‘ah reviews and advice on Sharī‘ah-compliant product development.</td>
</tr>
<tr>
<td>Sharī‘ah board</td>
<td>Specific body set up or engaged by an institution offering Islamic financial services to carry out, under the authority of the board, the institution’s Sharī‘ah governance function.</td>
</tr>
<tr>
<td>Sharī‘ah non-compliance risk</td>
<td>An operational risk resulting from non-compliance of the institution with the rules and principles of Sharī‘ah in its products and services.</td>
</tr>
<tr>
<td>Shock period</td>
<td>The period over which a shock is applied to a risk.</td>
</tr>
<tr>
<td>Significant owner</td>
<td>A person (legal or natural) that directly or indirectly, alone or with another person (legal or natural), exercises control over a risk.</td>
</tr>
<tr>
<td>Solvency</td>
<td>Financial soundness of a TU, including the ability to meet its obligations to takāful participants when they fall due. Solvency includes capital adequacy, liquidity, technical provisions, and other aspects addressed in an enterprise risk management framework.</td>
</tr>
<tr>
<td>Solvency assessment</td>
<td>A process for measuring the current and possible future solvency of a TU relative to the level of policyholder protection required by the solvency regime. This process includes assessing the effectiveness of a TO’s enterprise risk management within the constraints placed</td>
</tr>
</tbody>
</table>

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on the TU’s operation and the adequacy of the TU’s financial resources, including capital resources.

**Solvency control levels**
Levels of regulatory solvency requirements, which, if breached, trigger restrictions on the *takāful* operator or interventions by the supervisory authority. Solvency control levels may operate at the level of an entity, of a fund or of an insurance group.

**Solvency margin**
Excess of assets over liabilities. (Because these terms are frequently used in an imprecise manner, the glossary refers to available solvency (margin) or available capital and required solvency margin or required capital.)

**Solvency test**
The test showing compliance with domestic solvency requirements at a certain point in time (e.g. as of the balance sheet date), either by following a static approach – comparing available solvency margin with required solvency margin (i.e. the test must show $AS \geq RS$) – or a dynamic approach – that is, an actuarial test based on certain assumptions as to the risk parameters of the existing and potential future portfolio (e.g. mortality, investment yield, distribution of losses, expenses).

**Special purpose entity (SPE)**
A dedicated legal entity or a legally ring-fenced arrangement, specifically constituted to carry out the transfer of risk.

**Stakeholders**
Those with a vested interest in the wellbeing of *takāful* or *retakāful* undertakings, including:
- employees;
- *takāful* participants or cedants under *retakāful* arrangements;
- suppliers;
- the community; and
- supervisors and governments.

**Statistical quality test**
A test to assess the base quantitative methodology of the internal model, which demonstrates the appropriateness of the model inputs and parameters and justifies the assumptions underlying the model.

**Stochastic modelling**
A methodology which aims at attributing a probability distribution to certain financial variables. It sometimes uses closed form solutions, often involves simulating large numbers of scenarios in order to reflect the distributions of the capital required by, and the different risk exposures of, the TU.

**Strategic risk**
The risk created by a TO’s business strategy. Strategic risk includes risks arising from poor business decisions, substandard execution of decisions, inadequate resource allocation, or a failure to respond well to changes in the business environment.

**Stress testing**
A method of assessment that measures the financial impact of stressing one or more factors which could severely affect the TU.

**Subordinated loans/debt/qarḍ**
Loans/debt/qarḍ (liabilities) that rank after the claims of all other creditors and which are to be paid, in the event of liquidation or bankruptcy, only after all other debts have been met.

**Supervisory college**
A type of coordination arrangement to foster cooperation and coordination between involved supervisors with regard to the supervision of an insurance group, as well as to promote common understanding, communication and information exchange.

**Swap**
A type of derivative in which two counterparties agree to exchange streams of payments over time according to a predetermined rule.
Tabarru’ commitment The amount of contribution to be paid by the takāful participant to fulfil the obligation of mutual help and to be used to pay claims submitted by eligible claimants.

Tail value at risk (TVaR or tail VaR) Value at risk (VaR) plus the average excess over the VaR if such excess occurs over a specified amount of time. Sometimes also called “conditional value at risk”, it asks the question: “If things do get bad, how much can we expect to lose?”

Takāful A mutual guarantee, whereby a group of takāful participants agree among themselves to support one another jointly for the losses arising from specified risks, from a fund to which all commit to donate for the purpose. In this standard, includes retakāful unless the context requires otherwise.

Takāful fund A fund from which takāful participants' entitlements under takāful contracts are paid.

Takāful intermediary Any natural person or legal entity that engages in takāful intermediation.

Takāful intermediation The activity of soliciting, negotiating or selling takāful contracts through any medium where:

• “solicit” means attempting to sell takāful or asking a person to apply to participate in a particular kind of takāful from a particular TU for compensation;

• "negotiate" means the act of conferring directly with, or offering advice directly to, a purchaser or prospective purchaser of a particular contract of takāful concerning any of the substantive benefits, terms or conditions of the contract, provided that the person engaged in that act either sells takāful or obtains takāful from TUs for purchasers; and

• "sell" means to exchange a contract of takāful by any means, for money or its equivalent, on behalf of a TU.

Takāful operator Any establishment or entity that manages a takāful business – usually, though not necessarily, a part of the legal entity in which the participants’ interests are held.

Takāful participant A party that participates in the takāful product with the TU and has the right to compensation or other entitlements under a takāful contract.

Takāful undertaking An undertaking engaged in takāful business.

Takāful window A part of a conventional insurer/reinsurer (which may be a branch or a dedicated unit of that institution) that provides takāful or retakāful services.

Technical provisions The amount that a TU sets aside to fulfil its takāful obligations and settle all commitments to policyholders and other beneficiaries arising over the lifetime of the portfolio, including the expenses of administering the policies, retakāful and of the capital required to cover the remaining risks.

Total balance sheet approach A concept which recognises the interdependence between all assets, all liabilities, all regulatory capital requirements and all capital resources. A total balance sheet approach should ensure that the impacts of all relevant material risks on a TU’s (or a fund’s) overall
financial position are appropriately and adequately recognised. It is noted that the total balance sheet approach is an overall concept, rather than implying use of a particular methodology.

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Underwriting risk</td>
<td>The risk that is part of insurance risk other than claim reserve risk.</td>
</tr>
<tr>
<td>Underwriting surplus or deficit</td>
<td>The financial result from the risk elements of the business of a takāful fund or retakāful fund, being the balance after deducting expenses and claims (including any movement in technical provisions) from the contributions income.</td>
</tr>
<tr>
<td>Use test</td>
<td>A supervisory process to access whether the internal model, its methodologies and results are appropriately embedded into the TO’s risk strategy, risk management and operational processes for the TU.</td>
</tr>
<tr>
<td>Value at risk (VaR)</td>
<td>An estimate of the worst expected loss over a certain period of time at a given confidence level.</td>
</tr>
<tr>
<td>Wakālah</td>
<td>An agency contract where the takāful participants (as principal) appoint the takāful operator (as agent) to carry out the underwriting and investment activities of the takāful funds on their behalf in return for a known fee.</td>
</tr>
<tr>
<td>Wrong way risk</td>
<td>The risk that occurs when exposure to counterparties, such as financial guarantors, is adversely correlated to the credit quality of those counterparties.</td>
</tr>
<tr>
<td>Zakāh</td>
<td>An obligatory financial contribution disbursed to specified recipients that is prescribed by the Sharī‘ah on those who possess wealth reaching a minimum amount that is maintained in their possession for one lunar year.</td>
</tr>
</tbody>
</table>