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CONSUMER PROTECTION IN *TAKĀFUL*

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ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BCBS	Basel Committee on Banking Supervision
BNM	Bank Negara Malaysia
CBB	Central Bank of Bahrain
COBS	Conduct of Business Sourcebook
EU	European Union
FCA	Financial Conduct Authority
IAIS	International Association of Insurance Supervisors
ICPs	Insurance Core Principles
IFSB	Islamic Financial Services Board
OECD	Organisation for Economic Co-operation and Development
OFT	Office of Fair Trading
PIF	Participants' investment fund
PRF	Participants' risk fund
PCW	Price comparison website
RSA	Regulatory and supervisory authority
SRO	Self-regulatory organisation
TO	*Takāful* operator
TU	*Takāful* undertaking
UAE	United Arab Emirates
UK	United Kingdom
WP	Working Paper

ABSTRACT

This paper[1] examines regulatory and market practices issues relating to consumer protection in the *takāful* sector. Based on review of technical literature and a survey conducted across regulatory and supervisory authorities and *takāful* operators, it explores how an effective and comprehensive consumer protection regime can be applied, throughout the different stages of the customer's engagement with *takāful* operators and intermediaries.

The paper identifies challenges to consumer protection arising from asymmetry of information and difficulties of consumers in evaluating product quality and price, distribution and promotion practices, and from specific features of *takāful*. It identifies regulatory issues faced in designing and implementing effective and efficient consumer protection regulations and suggests ways to strengthen regulatory oversight of market players.

A large proportion of *takāful* sales in the consumer sector are distributed through traditional distribution channels. The analysis and survey results suggest that market practices can deviate significantly from supervisory expectations, particularly with regards to the scope for *takāful* operators and intermediaries to seek to maximise their own benefit rather than pursue the consumer's best interest. The conflict of interest often present, and the ability of market players to exploit this, suggests a potential for reputational damage to occur, threatening consumer confidence in the sector which is an essential attribute.

The paper recommends emphasis on fair treatment of consumers, to cover the whole product lifecycle from product development, through distribution to claims settlement, to reduce the potential for mis-selling and other forms of consumer detriment. It recognises that different jurisdictions take different approaches to addressing these issues.

[1] The author would like to thank former Assistant Secretary General, Mr. Zahid ur Rehman Khokher for his guidance and support towards the completion of this working paper. This acknowledgment is extended the members of the IFSB Technical Committee who reviewed and approved the paper. Many thanks to Mr Ahmad Al-Shammari and Dr. Abideen Adeyemi Adewale for their respective contributions at the early and later stages of the paper. Similarly, I appreciate the support provided by Ms Nur Khairun Nissa Md Zawawi and Mrs. Nazarina Abdul Majid of the IFSB Secretariat in distributing the survey to the IFSB member institutions. Finally, I am grateful to the insurance/*takāful* regulatory and supervisory authorities, *takāful* operators and other institutions who participated in the survey and for their useful comments during the revision of the draft paper.

The Working Paper also identifies evolving business models and the use of emerging technologies to re-engineer consumers' experience from the purchase of *takāful* products to filing of the claim, with benefits and threats that these changes bring.

The paper identifies regulatory and supervisory approaches to product oversight, disclosure, intermediation, privacy and data protection, complaints handling and claim settlement, including in matters specific to *takāful*, that could form a basis for a common framework in addition to the existing IFSB standards and guiding principles. Besides, consideration should be given to consumer education on *takāful* and the ways in which it could be delivered.

EXECUTIVE SUMMARY

Overview

The conduct of business of providers and intermediaries of insurance products (including *takāful*) in relation to consumers is a matter of widespread regulatory attention. This paper examines the related issues. It takes the term 'consumer' to mean those customers less able to protect themselves against unfair treatment. It describes the rationale for, nature and implementation of consumer protection regulation from a conceptual perspective. Empirical evidence is also provided from the literature and from a survey conducted to collect information on regulatory measures currently applied to the business conduct of *takāful* operators (TOs) and intermediaries. The survey covered regulatory and supervisory authorities (RSAs) with responsibility for *takāful*, from 11 jurisdictions. Views and practices of 29 TOs from four jurisdictions were also surveyed. Based on the analysis and discussion, areas for potential development of IFSB standards are identified, and examples provided in the annexe of practices that could be recommended in such standards.

Conceptual analysis and literature review

The review of the literature shows that a number of characteristics of retail insurance products can create conditions for providers or intermediaries to take advantage of consumers, potentially undermining consumer confidence in the sector. Issues and practices with this potential include asymmetry of information, product quality, price, distribution and promotion practices and some specific features of *takāful* products.

Information asymmetry is a recognised issue in the field of insurance. The product typically has many conditions and features, setting out for example the levels of cover, exclusions, optional extras, and the duties of the policyholder. In the case of *takāful,* the contract has further complexities compared to conventional insurance products, for example in the remuneration structure for the operator. Consumers typically lack the ability to assess a financial services contract, or to negotiate its terms to their advantage. This inequality between the provider and the consumer serves as a significant justification for regulation.

In addition to access to information and ability to interpret it, providers may also, in the absence of regulation, be able to control how information is framed and presented to the consumers by varying the explanation or the relative prominence of product features, and so influence consumer decisions contrary to the consumer's own

interest. Mere disclosure may not be adequate to mitigate these risks. Concerns over fair treatment of consumers in this respect are strongest in the case of long-term savings and protection products where decisions on purchasing or modification are made only infrequently.

Pricing regulation poses practical difficulties where contracts vary in form, as regulated pricing cannot easily reflect nuances in cover and conditions of contracts, or changes in exogenous factors for example, longevity or weather that affect may affect contracts differently. Where this is evident, comparison of products along price and quality dimensions presented by *takāful* operators or intermediaries may yield little result even where premium varies with risk characteristics of individual consumers.

Much consumer *takāful* is sold through intermediaries rather than directly. The activities of intermediaries can range from promoting *takāful* awareness to identifying the suitability of products for consumers' needs, and delivering *takāful* products. Consumer protection concerns may arise from distribution practices that promote adverse consumer outcomes, perhaps due to conflicting incentives or failure to exercise due skill. The traditional basis of remunerating intermediaries on a commission basis may work against fairness to consumers, particularly where the seller has a significant advisory role to play in the consumer's choice of product. Regulation can set minimum standards for objectivity and quality of advice, or prohibit particular incentive structures.

Promotional activities conducted by providers or intermediaries may affect consumers' perceptions of products and influence their behaviour. Misleading advertising or product brochures can impair the consumer's ability to make an informed decision. Advertising and other promotional materials should thereore be fair, clear and not misleading. In *takāful,* further issues may arise. For example, using surplus distribution as a selling point in general *takāful* raises the risk of creating unrealistic expectations as to future financial performance.

Evolving business models and the use in *takāful* of emerging technologies can create additional opportunities for consumer detriment to occur, and require regulatory consideration. Growth in digital services is changing customer expectations, preferences, and the nature of TO and intermediary interactions with customers. These developments can challenge the adequacy and effectiveness of traditional regulatory and supervisory frameworks in respect of conduct of business.

Consumer confidence is essential for the sound development of the personal lines *takāful* sector. To maintain this confidence, regulators in all jurisidictions pay attention, though in different ways and with different levels of intervention, to matters such as the comprehensibility of products, the actions taken by operators and intermediaries to assess suitability, the impact on consumers of practices in pricing and contract terms, disclosures, the fairness of complaints and claims handling and the appropriateness of marketing materials. Approaches range from the principles-based, whereby rules are set within which operators and intermediaries must operate, and emphasis is placed on governance, with compliance verified by the supervisor, to interventionist approaches where some or all of contract terms, prices and marketing materials are prescribed or subject to regulatory pre-approval or filing. In practice, the literature suggests that supervisors adopt a mix of principles-based and prescriptive elements.

Survey results

The results of the survey of RSAs conducted to support the analysis illustrate in greater detail the approach of RSAs with responsibility for *takāful*. Almost all have an explicit mandate for consumer protection, with powers to enforce requirements. They appear typically to place emphasis on regulatory supervision of contract terms and marketing materials, with pre-approval or filing requirements common. Some apply a principles-based approach with focus on desired outcomes, while others are more prescriptive as to product oversight. All look at the relevance of covered risks to the target market; the appropriateness of contract terms for the target customers; and the appropriateness of pricing for the customer. Most require the performance of some form of suitability determination, at the product development stage or at point of sale (e.g. through a documented needs analysis or confirmation of advice), particularly for family *takāful*. 'Free look' or 'cooling off' periods are typical components of the framework.

The jurisdictions surveyed emphasise disclosure. Disclosure requirements typically require presentation of key features of the contract in a prescribed standard format, as well as the full contract wording. They also cover brochures and promotional materials, and periodic statements. In a *takāful* product, relevant disclosures would include issues relating to *qard, wakalah* fee*,* costs and (where offered) surplus distribution.

As compliance with Sharī'ah is of the essence of *takāful*, and critical for consumers who are Muslims, RSAs typically pay attention to this matter at the product development stage, but with different detailed approaches. Sharī'ah approval is

typically required for contracts and for marketing and communication materials, by the firm's own Sharī'ah supervisory committee. Some jurisdictions also require scrutiny by a central Sharī'ah body (where this exists).

Post-sale supervision is also regarded as important. RSAs monitor the effectiveness of a TO's own controls over the quality of ongoing policy servicing and disclosure.

With regard to supervision of *takāful* intermediaries, approaches vary as do institutional requirements. Most respondents apply direct supervision setting licensing requirements for intermediaries and monitoring their compliance. In some cases direct supervision is delegated to a self-regulatory organisation (SRO) which registers *takāful* intermediaries and requires professionalism and good business conduct. TOs bear some responsibility in either case, for the activities of their own appointed intermediaries.

Most respondents regulate client money in the intermediaries' hands, requiring adequate financial controls, record-keeping and traceability of client money, with more or less stringent requirements as to segregation and credit terms. Some, but not all, make the TO bear the risk of client money in the intermediary's hands. Some do not allow intermediaries to handle client money.

The supervisory review process relating to treatment of consumers uses different tools, principally thematic review, on-site inspections and off-site inspections. Enforcement measures available included directions to address an issue, penalties, redress and ultimately restriction or withdrawal of licence. Respondents emphasised the importance of proportionality, and the need for due process including right of appeal.

RSAs' responses to questions on dispute resolution highlighted requirements for TOs and intermediaries to have policies and processes, compliant with minimum standards, for complaints handling. Some juridictions had alternative dispute resolution mechanisms (arbitration forums or an "ombudsman") to deal with unresolved disputes while some, supervisors themselves have a direct complaints handling role.

As well as RSAs, TOs were also surveyed. TOs were questioned on their different practices with regard to engagement with customers, from product design and pricing through sales, post-sales servicing and claims handling to final settlement, as well as ongoing review of product performance.

Some TOs, in addition to disclosing the required information, required the customer to acknowledge that they had received and understood the information provided, to

manage mis-selling risk. TOs also emphasised that proper assessment of suitability required the consumer to make appropriate disclosure to the TO. Methods used to obtain this information were described. Some require customers to sign confirmations of advice upon which the suitability assessment and recommendation is based, and to declare that the product concerned is suitable for the customer. Not all TOs, however, provide formal statements of advice.

Most TOs sell through intermediaries, usually using many intermediaries, some of whom may also sell products of other TOs. The standards that TOs require of intermediaries vary, and to some extent this reflects different regulations in the different jurisdictions. All TO respondents, however, require intermediaries to meet standards of competence.

Few respondents, RSA or TO, commented on issues relating to emerging distribution channels. Some RSAs have licensed price comparison website/aggregators, but this is still in an experimental way (sometimes referred to as a "regulatory sandbox" approach) to allow the RSA to assess the risks involved. Those respondents who did comment mentioned issues such as the use of websites to provide information, and the importance of cyber-security.

Conclusions

The conduct of insurance business in consumer lines is vulnerable to the risk of inappropriate consumer outcomes. Key drivers include the providers' control over information on products and prices and how that information is presented to consumers, the possibility of conflicts of interest influencing provider behaviour, and the limited ability of consumers to evaluate information presented – emerging technologies also present additional challenges. The potential for consumer detriment is particularly high for certain long-term products. Specificities of *takāful*, though giving effect to the requirements of Sharī'ah, can provide scope for further manifestation of these risks. Attention is drawn to conflicts of interest in *takāful* models, and issues arising from surplus distribution.

Regulatory frameworks for *takāful* in different jurisdictions use a combination of approaches to mitigate risks of adverse consumer outcomes, addressing among other things TOs' and intermediaries' product oversight, disclosure, intermediation, privacy and data protection, complaints handling and claims settlement, including in matters specific to *takāful*. Any standard framework for general adoption would need to provide

flexibility for RSAs to adopt it within the context of their own institutional and market structure, as well as recognising the different risk attaching to different consumer products.

Areas which the IFSB could consider for standard development include principles for the development of national regulatory frameworks; documentation of widely-used approaches such as complaints handling requirements and suitability determination; guidance on identification of types of business and circumstances where stronger regulation is justified; guidance on supervision of matters such as Sharī'ah compliance and activities of intermediaries, where institutional structures may vary; and guidance on supervisory review approaches to the conduct of *takāful* business. Illustrative practices that could be recommended in such a framework are provided. In addition, consideration should be given to consumer education on *takāful* and the ways in which this could be delivered.

SECTION 1: INTRODUCTION

1.1 Background

This paper presents the results of research into consumer protection in *takāful*. It is appropriate to comment initially as to its scope.

Consumer protection is an ultimate goal of much regulation in the insurance (and *takāful*) sector, including that aimed at ensuring that providers of the product will be able to meet their contractual obligations as they fall due. Regulation falling under the heading of prudential regulation (e.g. solvency, corporate governance and risk management) falls largely outside the scope of this paper, which concentrates on the treatment of consumers by insurance and *takāful* providers and intermediaries and under laws applicable to such contracts, and therefore on what is commonly termed "conduct of business" regulation.

This paper focuses on the consumer. There is no universally accepted definition of this term. In this paper, "consumer" is taken to mean an actual or prospective policyholder[2] or beneficiary who is unlikely to possess or have access to the knowledge, expertise or financial resources to negotiate and make informed decisions about the terms and conditions of the insurance or *takāful* contract being offered, or to identify and assert their rights against the provider under the contract or the regulatory framework if things go wrong.

Individuals purchasing, for example, private motor, household, individual health or individual family *takāful* are examples of consumers. Consumer protection measures are typically aimed at customers of this nature. Some jurisdictions extend consumer protection measures to small businesses. On the other hand, corporate clients purchasing *takāful* for large commercial risks, or cedants under *retakāful* contracts, would not be consumers in this sense, as they may be assumed to possess the necessary ability to negotiate from an informed position. Nonetheless, considerations such as fair treatment, ethical behaviour, good faith and the avoidance of abusive practices remain relevant to *takāful* operators' (TOs') dealings with such clients. Some regulatory and supervisory practices described in this paper may be suitable for application, in a proportionate manner, to those dealings.

[2] In *takāful* the term is participant. To avoid confusion with other meanings of the term associated with the insurance industry, and for brevity, this paper uses the term 'policyholder' to include both a policyholder under a conventional insurance contract and a participant under a *takāful* contract.

This paper examines consumer protection as applicable to *takāful*. *Takāful* is a Sharīʿah compliant alternative to conventional insurance for protection against events that cause loss or other detriment. Its defining feature as compared to conventional insurance is that it operates according to Sharīʿah principles. A group of participants agree to contribute into a mutual pool (participants' risk fund) out of which indemnities are paid to participants or beneficiaries upon the occurrence of specified losses.[3] In family *takāful*, the fund includes a savings and investments component out of which benefits are paid on specified life events, to nominated beneficiaries or to the participant's estate. The participants' risk funds (PRF) are managed, in accordance with Sharīʿah principles, by a TO who is remunerated for that management, usually by a portion of the policyholders' contributions and a share of investment earnings. Typically, the TO and the funds form part of a single corporate entity with internal segregation of funds, however a number of different models exist.

The *takāful* industry has experienced growth with increased uptake and awareness of Islamic finance generally, particularly in countries with a significant Muslim population.[4] Consumers of *takāful* are not restricted to Muslims, and non-Muslims may be attracted by features of this alternative to conventional insurance, where it is available. It was reported in 2010 that most *takāful* companies in Malaysia then averaged 30-40% non-Muslims among their policyholders.[5]

Countries where *takāful* operates include a number of low income countries, and insurance penetration rates in countries with significant *takāful* presence are generally low.[6] A correlation has been drawn between low insurance penetration rates and low levels of income, and limited awareness and understanding of insurance contracts.[7] Equally, these present growth opportunities for *takāful*.[8] The number of institutions offering *takāful* products increased from 195 in 2010 to 305 in 2016.[9]

For personal lines (those typically sold to consumers), the terms of *takāful* contracts are predominantly decided by the provider. Policyholders therefore rely upon the provider for fair treatment in the sales and performance stages of the contract. The market relies heavily upon trust and consumer confidence. However, consumers may not fully understand the limitations of the cover that they are acquiring and the

3 In practice, for consumer products, the initiative to form the pool is that of the operator rather than the participants, and the operator offers participation in the pool in the retail market.
4 IFSB IFSI Stability report 2018
5 Syed Moheeb Syed Kamarulzaman (Dec. 2010)
6 SwissRe (2018), Re/insurance in the Middle East and Pakistan.
7 Rudolf Enz (2000)
8 Bhatty (2007).
9 IFSB IFSI Stability Report (2013-2018)

obligations that the contracts impose on them. Consumers may also lack the resources to seek any redress that the contract offers. Specificities of *takāful* such as *wakālah*, *qarḍ* and (where this is a feature) surplus distribution add to the complexity of the contract. In both conventional insurance and *takāful*, asymmetry of information, understanding and financial power implicit in the relationship between consumers and providers or intermediaries can create conditions for providers or intermediaries to take advantage of consumers. Adverse consumer outcomes can result in individual cases, and high-profile incidents of market failure (such as mis-selling scandals) can undermine consumer confidence in the sector.

In many countries, personal lines *takāful* products are largely intermediated, rather than being sold directly by the provider. Intermediaries may be representatives of the TO or may be independent. In the case of bancassurance/*bancatakāful*, the intermediary is itself a major financial institution

Intermediaries distributing the products of insurers and *takāful* operations are potential sources of risk to the insurers and TOs concerned and to the consumers, as intermediaries' incentives (including commissions and fee structures) may be misaligned with either or both of the insurer and the consumer, and encourage selling practices that disadvantage the consumer (and possibly the insurer).[10] Some regulatory frameworks seek to moderate the scope for misalignment by restricting the incentives of the intermediary. In general *takāful*, the TO also acts as intermediary in that it manages the risk fund but (unlike a conventional insurance company) may not bear the consequences of inappropriate business acceptance actions, and may therefore have misaligned incentives. It also acts as intermediary in family *takāful*, in a similar manner so far as concerns the risk fund but also in a manner more similar to that of an asset manager for those forms of family *takāful* products where the consumer's key interest is in the actual and future performance of the investments, heightening the potential impact of inappropriate illustrations at the point of sale, and the importance of periodic disclosure of actual performance.

Technological developments in the sector, such as the use of digitisation for targeted pricing, can improve the experience of customers and the efficiency of insurance provisions, however they can also result in unfair outcomes for some consumers; they may have the effect of leaving some consumers without access to insurance.

[10] This is a manifestation of the 'agency problem' where an agent is supposed to act in the interests of its principal, but lacks appropriate knowledge or incentives to do to, resulting in an unsuitable outcome for that principal, as articulated in Ross, Stephen A. 1973. The economic theory of agency: The principal's problem. American Economic Review 62(2): 134-139.

Developments of this nature require supervisors to maintain an up-to-date understanding of the way products work and to balance the benefits of innovation against the potential for consumer detriment.

In view of the factors described, regulatory policymakers recognise a need to promote fairness, and responsible and professional conduct by TOs and intermediaries in dealing with consumers.

A key objective of regulation of the conduct of business is to maintain confidence among policyholders and potential policyholders that the fairness of the sales process can be relied upon, that the products offered will meet their needs, and that providers will perform their obligations under those products in a manner that does not exploit asymmetry in information and financial power. These objectives support wider aims of financial inclusion and economic benefit arising from the use of insurance products to provide protection and accumulation.

Accordingly, this paper proceeds from the premise that appropriate standards of conduct of business with regard to disclosure, advice and claims payment, coupled with effective consumer redress mechanisms and moderation of any disproportionate impacts of contract law, can promote fair treatment of consumers and confidence in *takāful* as a mechanism for risk mitigation in daily life. However, these aims can be frustrated by consumers' low levels of understanding of financial risk and risk management, contract performance or technological developments.

International standards adopted by the International Association of Insurance Supervisors (IAIS) promote consumer protection.The Insurance Core Principles (ICPs) issued by the IAIS, and in particular ICPs 18 and 19 (on intermediaries and on business conduct, respectively), provide a potential framework for development of an approach to consumer protection in *takāful*. Such an approach would take into account the specific characteristics of *takāful* as compared to conventional insurance.

1.2 Objectives and Scope

The Islamic Financial Services Board (IFSB) and the IAIS, in their Joint Paper on "Issues in Regulation and Supervision of Takāful (Islamic Insurance)" issued in August 2006, identified a need to develop standards and interpretations for *takāful*, to provide appropriate levels of consumer protection in terms of both risk and disclosure and to support the orderly development of the *takāful* industry in terms of acceptable business

and operational models, and the design and marketing of *takāful* products.[11]The joint paper accordingly identified "transparency, disclosure and market conduct" as an area in which the IFSB could develop specific guidance for the *takāful* industry in the form of adaptation of the relevant ICPs.[12] For this area, ICP 18 on intermediaries and ICP 19 on consumer protection are particularly relevant.

In furtherance of the objectives of the joint paper, the Technical Committee of the IFSB, in its 40th meeting in Kuala Lumpur, Malaysia, on 25 October 2016, recommended the Council of the IFSB to approve the preparation of a research paper entitled "Consumer Protection in the Takāful Sector". Subsequently, the Council, in its 29th meeting held on 14 December 2016 in Cairo, Egypt, approved the development of this research paper as part of the IFSB Work Plan for 2017. This paper is among the research papers proposed in the Strategic Performance Plan 2016-2018. It is one of a number of initiatives aimed at furthering the ongoing objective of strengthening the regulatory framework for the *takāful* sector.

This research paper has the following objectives:

a. to study regulatory issues relating to consumer protection with an emphasis on the *takāful* sector;
b. to explore how current consumer protection regulations are being applied at different stages of engagement with *takāful* consumers, from product design to sales, claims handling and dispute resolution; and
c. to identify challenges faced in designing and implementing effective and efficient consumer protection regulations.

This paper examines the rationale for, and nature of, consumer protection regulations from a conceptual perspective and presents empirical evidence on the extent to which consumer protection regulations exist to address the related issues. It is prepared with the intention of assisting in the design of consumer protection measures that are suitable for the sector.

1.3 Structure of the Research Paper

The paper is organised as follows: Section 2 presents a review of the literature on the concepts and development of consumer protection regulation in the insurance sector,

[11] IAIS and IFSB, 2006, paragraph 11.
[12] ibid, paragraph 43.

with particular reference to the *takāful* industry. This section consists of three subsections: an introductory comment; followed by discussion of the economic rationale for conduct of business regulation as applicable to the insurance sector, both in general terms and with specific reference to the *takāful* industry; and discussion of approaches to consumer protection regulation in the insurance and *takāful* sector. Sections 3 and 4 present findings from a survey conducted, for the purposes of this paper, on approaches to consumer protection in a selection of jurisdictions. Section 5 summarises challenges in providing consumer protection regulation and possible recommendations to address those challenges.

SECTION 2: OVERVIEW OF THE DEVELOPMENT OF CONSUMER PROTECTION REGULATION IN THE INSURANCE SECTOR WITH REFERENCE TO THE *TAKĀFUL* INDUSTRY

2.1 Introduction

This section reviews the literature on the development of consumer protection regulation in insurance markets. Literature on this area relating exclusively to the *takāful* sector is very limited. The review is derived from a number of academic papers and materials published by institutions that develop national and international standards for the protection of financial consumers. The review has particular regard to materials published by the IAIS, and also refers to materials of other international or supranational institutions such as the International Financial Consumer Protection Organisation (FinCoNet), the Joint Forum (comprising the Basel Committee for Banking Supervision [BCBS], the International Organisation of Securities Commissions and IAIS), the Organisation for Economic Co-operation and Development (OECD), the European Union and the World Bank, focusing on financial consumer protection regulation and supervision. In addition to materials relating to the insurance or financial sector more generally, reference is also made to materials published by the IFSB[13] and the International Monetary Fund which discuss consumer protection in the specific context of Islamic financial services.

It has long been recognised that insurance in general is prone to business conduct risk. Increasing perceptions of consumer detriment arising from behaviour of insurance institutions, along with increasing consumer activism and awareness of rights, have in some countries resulted in reputational damage in the sector and costly compensation exercises. The perceived vulnerability of consumers as recorded in a number of cases of mis-selling and other forms of abuse in different countries has emphasised the need for consumer protection regulation.[14]

Insurance regulators view conduct of business as an important priority, since insurers are critically dependent on the continued confidence of their customers. Regulation and supervision aimed at safeguarding consumers' confidence in the sector help to avoid poor practices that could undermine the stability of the sector, and provide credibility to the market.[15] Consumer protection measures adopted in different

[13] See IFSB (2009a), IFSB (2009b) and IFSB- WP-6 (2015)
[14] Tennyson (2011) p.191; Erta et al. (2013).
[15] The World Bank Consultative Draft (2009)

countries vary widely but examples include requirements for proper oversight of conduct, product governance, suitability and appropriateness assessments, disclosure and incentive alignment.

2.2 Economic Rationale for Regulation of Conduct of Business in the Insurance and Takāful Market

In order to present a clear framework for this paper, this section discusses the rationale for effective consumer protection regulation generally in the insurance sector and, in particular, as relevant to *takāful*.

The UK Financial Services Authority (FCA) published in 1999[16] a paper in which Professor David Llewellyn analysed the economic rationale for financial regulation. The paper identified three core objectives of financial regulation, being to sustain systemic stability, to maintain the safety and soundness of financial institutions, and to protect the consumer. The present paper focuses on the third of these (and within that, specifically on the conduct of the institution towards the consumer). The rationale for consumer protection is premised by Llewellyn on various concerns associated with market imperfections (especially asymmetric information) which, in the absence of regulation, may produce sub-optimal outcomes with negative consequences for consumer welfare. Therefore, the purpose of regulation is to mitigate the identified market imperfections.[17]

Llewellyn highlights that regulations and supervisory actions provide incentives for operators to adjust their actions and behaviour, and to control their own risks internally. One of the key questions that arise is the extent to which behaviour of market participants can be altered by way of externally imposed rules, or by creating incentives for operators to behave in a particular manner.

In Llewellyn's analysis of the rationale for regulation of retail (as opposed to wholesale) business, he identifies a number of features of retail financial services that lead him to conclude that market imperfections are more pervasive in the retail sector than in the wholesale sector, and that it is appropriate for retail financial services to be regulated. These include: the infrequency of repeat orders by small-volume retail consumers,

[16] Lewellyn (1999).
[17] ibid, pp. 9.

giving the consumer little opportunity to learn from experience, and reducing the incentive for firms to offer quality products; the asymmetry of information and inequality of the suppliers and demanders in the retail market; the limited ability and opportunity of the consumer to acquire the necessary skills to enter into complex financial contracts; the difficulty for a consumer to monitor the behaviour of the supplier; the prevalence of advised sales, raising potential principal-agent problems; and the difficulty for retail consumers to judge the safety and soundness of financial institutions.[18] In a different analysis, sources of market imperfections identified in the insurance sector include: (a) asymmetric information; (b) product quality characteristics; (c) price; (d) promotion; and (e) distribution.[19]

2.2.1 Asymmetry of information

The consumer may lack sufficient information, or the ability to assess the information that they do have. The consumer then needs impartial advice if decision making is to be on an informed basis. Insurers' (in *takāful*, TOs') representatives and intermediaries have significant informational advantages over the consumer (in particular, in relation to the context and interpretation of the information that is supplied to the consumer), and this information advantage could be exploited against the consumer's interests.[20]

Disclosure-based measures intended to mitigate information asymmetry may have inherent limitations. Behavioural economists suggest that retail financial consumers' decision making does not always reflect their own needs and preferences, rather, it may be driven more by emotion or other non-rational factors.[21] In this context, making a choice, on the basis of limited information, between complex product options is difficult. As a result, they may choose products or services which on a rational basis are not best suited to their needs. The concept of bounded rationality has been developed in the literature to describe the limits on the capacity of individual consumers to collect and process information and to deal with complexity, creating the opportunity for exploitation by better-informed suppliers or intermediaries, whether that exploitation is deliberate or not.[22]

Inherent limitations on the rationality of consumer choices affect market outcomes, making those outcomes potentially inefficient due to consumers' sometimes

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18 See footnote 14, pp. 41-42.
19 Diacon and Ennew (1996); Murphy, et al. (2007).
20 See IFSB (2009a).
21 See Fatas and Lyons (2013).
22 On bounded rationality, see definition in ibid, pp. 19.

unconscious biases and cognitive limitations. The literature identifies opportunities for businesses to exploit behavioural biases even if consumers are presented with all the information that in principle is required to make informed decisions. The consumer faces two potential problems – getting the necessary information, and processing it, and regulation may assist in these processes. Simplifying and standardising product information improves consumer decisions in terms of choice between similar products.[23]

Similar to other financial products and services, insurance (*takāful*) products and services can, because of their multiple features, challenge the ability of consumers to make informed decisions. A *takāful* or insurance contract typically has multiple conditions governing the levels of cover, exclusions, optional extras, and the duties of the policyholder. Automatic renewal provisions or, in life insurance or family *takāful*, provisions for lapse, surrender, switching or indexed premiums (contributions) are further examples of possible contract features that may complicate understanding and comparison. In the absence of regulatory constraints, insurers may be able to control how the information is framed and presented to the consumers by varying the explanation or the relative prominence of product features (e.g., the percentage *wakālah* fee/profit sharing rate of *takāful* contract versus the total cost, including all add-on fees). Products may be presented with attractive offers, leading consumers to decide on the basis of what is presented as salient rather than on the overall nature of the product. These concerns are of particular significance in the case of long-term savings and protection products where decisions on purchasing or modification are made only infrequently.

The problem of asymmetric information is recognised in existing IFSB Standards.[24] Because of this problem of asymmetric information, it may be difficult for consumers to evaluate *takāful* undertakings (TUs) as potential providers of the desired product, or to monitor their performance (particularly in the case of family *takāful* products where actual and prospective investment performance would be of importance to informed decision-making). The TO may take advantage of its control of information and the opaque nature of the TU that it manages, to act in its own interests rather than those of its policyholders.[25] IFSB-8 further comments that: “It is a commonplace that most insurance, outside compulsory lines such as motor and (sometimes) health, is “sold”,

[23] Gaudeul and Sugden (2012).
[24] IFSB (2009a) and IFSB (2009b).
[25] IFSB (2009a), para. 58.

rather than “bought”. In circumstances where the initiative lies with the seller, potential *takāful* participants will have even less chance than usual to evaluate the financial strength of the *takāful* fund.”[26] IFSB-8 emphasises the importance of timely disclosures in assisting the policyholders to make an informed decision on their selection of the investment portfolio.[27] This is important both when the contract is initiated and subsequently when the policyholder might wish to revise that selection.

Making optimal decisions about financial products often requires the examination of considerable information on terms and conditions, in addition to prices. This is especially true in the case of long-term family *takāful* products where decisions are undertaken only infrequently. TOs and intermediaries will be the most efficient suppliers of information and advice (where this is required) on the impact of terms and conditions on the suitability of products. This creates an additional rationale for regulation to require TOs to produce particular items of information. However, there are limitations on the extent to which disclosures alone can effectively mitigate information asymmetry, if consumers either do not understand the information or believe that it is not relevant to their decision-making. On the other hand, measures aimed at improving disclosure and transparency can help to promote competitive markets, by allowing consumers to make comparisons between products and service providers.[28]

Regulations on conduct of business may set out requirements for objectivity of advice, with the aim of minimising potential principal-agent problems that can arise when principals (those seeking advice-in this case, consumers) and agents are not equally well informed. Where this is the case, requirements for suitability determination may help mitigate the inherent defects of reliance solely on disclosure, provided that the suitability assessment is performed from the perspective of the consumer’s interests. Conduct of business regulation can also include procedures for compensation where the interests of a consumer have been compromised by the behaviour of a financial institution.[29] Observation of compliance rules may also improve the governance of product providers (insurers and TOs) and intermediaries by helping them to identify potential risks before problems occur (including in relation to unrelated matters - for example, anti-money laundering requirements).[30] In order to improve the ability of consumers to benefit from such qualitative obligations on providers, policymakers may

[26] ibid.
[27] ibid, para 59.
[28] Lefevre and Chapman (2017).
[29] Goodhart et al. (2013), p. 6.
[30] Chatterjee (2009) p. 85.

also seek to raise consumers' information awareness and skills through the provision of financial education.

By understanding what processes influence consumer behaviour, measures to mitigate the harmful impacts of poor decision making them can be incorporated into regulatory and supervisory practices to strengthen financial consumer protection.

2.2.2 Product Quality Characteristics

This subsection focuses on ways in which product quality characteristics influence consumer decisions. The quality of products offered to consumers can determine the success and survival of an insurer. This is particularly the case in highly competitive insurance markets. Offering products that meet the needs of consumers may enable an insurer to gain a competitive advantage and build a long-term relationship with consumers.[31]

In insurance contracts, including *takāful*, the contractual relationship is defined and established at the point of contract, and a clear explanation of contractual relationship is required at this point. Ethical business conduct is critical both at this point and after the point of contract - that is, when the insurer is performing the contract (charging premiums, paying claims and, in the case of many life insurance and family *takāful* products, managing the policyholder's accumulated funds for the benefit of the beneficiaries over what may be a term of many years). In this context, the policyholder's interest is not limited to the quality of the product at the point of sale, but also includes the financial performance of the product over time, to inform decisions as to whether to remain in the contract, to seek a new provider or to make changes in the investments in which the accumulated funds are invested (where those options are available). In view of that, both information provided on products before sale, to permit informed decision-making at that point, and information provided post-sale, to permit assessment of performance, are important and both are subjects for regulation.

Consumers may however face difficulty judging product quality, in part due to the information asymmetry already referred to. The qualitative characteristics of a typical insurance or *takāful* contract include the strength of both the provider's ability and its willingness to pay losses and the size of loss events covered under the policy.[32] This is particularly the case with products that are long-term in nature or that address risks

[31] Gronroos (1994; 2011) & Gummeson (1994).
[32] Liedtke and Monkiewicz (2011); Tennyson (2008).

of particular significance to the policyholder. The qualitative characteristics of the product may be difficult to ascertain due to the contingent nature of the services provided (e.g. claims handling and payments, which occur only on an uncertain event), the potential opacity of which expenses are charged to the policyholders' fund and which are borne by the TO out of its fees, and the fact that services may be provided over a long time (e.g. management of investments under a long-term life insurance or family *takāful* product representing a significant provision of the policyholder for retirement income or for patrimony).

Consumers may also be ill-equipped to assess whether the product they are offered is appropriate for the purpose for which they are seeking cover. Insurance and *takāful* contracts typically include detailed statements (the "small print") setting out conditions and exclusions, and it is possible that a consumer will be offered a contract that in fact excludes the risk for which the consumer sought cover, or the risk that the provider or intermediary recommending the purchase held it out as covering. Examples of the former might include travel policies that do not cover activities that the policyholder intends to pursue, or medical and health covers that exclude diseases for which the policyholder seeks cover, and examples of the latter might include payment protection insurance that does not respond in any circumstances that the policyholder might encounter.[33]

Technological developments such as telematics and automated advice raise the risk that a consumer will fail to understand the qualitative aspects of the product, and will be sold an inappropriate product.[34]

In addition to mismatch as to the coverage obtained, claims settlement disputes may arise for other reasons, indicating a need for consumer protection. Tennyson observes in Liedtke and Monkiewicz (2011) that such disputes may arise due to "differences in beliefs about the validity of a claim under the terms of the insurance policy, or value of compensable losses experienced." Specific disputes cannot be anticipated and contracted over at the time policy purchase".[35] Principal-agent problems may also emerge; as Tennyson comments, an insurer may benefit financially by refusing to pay a claim, reducing a claim, or delaying settlement as a negotiating tactic.[36] Whilst that direct financial incentive may not be the case where a TO does not participate in

[33] For a study of payment protection insurance and related consumer protection issues, see European Insurance and Occupational Pensions Authority (2013), Opinion on Payment Protection Insurance and the accompanying Background Note.
[34] IAIS (2018a).
[35] Tennyson (2011a), p.193.
[36] ibid pp. 193-4.

surplus, a TO may still have indirect incentives to deny, reduce or delay payment (e.g., to improve surplus for distribution).

As also observed by Llewellyn, the value of an insurance contract (in this context, the value of a *takāful* product to the policyholder) is determined in part by the behaviour of the supplier after the contract has been committed to, creating the potential for opportunistic behaviour, and no amount of information available at the point of purchase can guard against this potential hazard.[37] Llewellyn notes that consumers may not purchase products they believe may be beneficial because they are unable to distinguish between high and low quality products.[38] In this respect the product provider has a fiduciary relationship with the policyholder, justifying regulation.

Llewellyn cites Howard Davies in a 1999 lecture stating that regulation gives consumers some independent assurance about the terms on which contracts are offered, the safety of assets, which underpin them, and the quality of advice received. Consequently, setting minimum quality standards enhances confidence in the market which is beneficial to insurance institutions as well as it keeps low-quality producers out of the market.[39] Llewellyn also cites press reports, a Parliamentary report and a regulator as blaming increasing reluctance by customers to take on long-term commitments (particularly, in sales of life insurance and pension products) on a wane in consumer confidence following a series of well-publicised scandals and hazardous selling practices.[40]

2.2.3 Price

Insurers and intermediaries, through underwriting activities, price risk, and provide for risk transformation, pooling, and reduction.[41] In theory, in a competitive market prices would reflect the expected value of policyholders' insured losses (and associated net costs).[42] Pricing or availability of insurance is often tied to the policyholder's loss experience and the perceived riskiness of the policyholder's behaviour. For example, in automobile liability insurance policyholders who represent a greater accident risk are, other things being equal, expected to have higher insurance premiums. Where this is evident, consumers may have an economic incentive to control the risk they

37 Llewellyn (1999), p.37.
38 ibid, p. 25.
39 ibid, p. 25-26.
40 ibid, p. 26.
41 See Skipper et al. (2000).
42 ibid.

represent (though this may not always be the case, for example if pricing is influenced by group membership, such as age cohorts, rather than individual characteristics).

Actual regulation of pricing poses significant practical difficulties where contracts vary in form, as regulated pricing cannot easily reflect nuances in cover and conditions of contracts, or changes in exogenous factors (say, longevity or weather) that affect different contracts differentially.[43] Pricing regulation is easier to impose where the form of products is standardised, with no or limited scope for customisation of products for particular circumstances or customers. Adverse selection is a possible consequence of price regulation under such circumstances, though where cover (according to a prescribed form) is compulsory this risk may be capable of at least partial containment.[44]

Comparison of products along price and quality dimensions presented by TOs or intermediaries may yield little result even where premium varies with risk characteristics of individual consumers. Premium rates can depend on a variety of factors such as medical history, the condition of the insured property, or financial history, depending on the type of insurance. These features of the contracts increase the potential for seller misrepresentation or consumer misunderstanding of transactions.

Research in behavioural economics provides explanations as to why consumers face difficulties in processing information and, in particular, in making decisions based on price. Insurers and, in particular in some markets, intermediaries may have an incentive to adopt pricing strategies that obscure information so that consumers pay a higher price or buy a lower quality than would be best for them.[45] Examples of such strategies include price framing and complex pricing (such as drip pricing, baiting, price partitioning), which may be deployed by firms to influence consumer behaviour. “Drip pricing” is the term used to describe the practice of advertising a low headline price aimed to attract consumers. As the consumer invests time in gaining more information about the supplier’s offer or in initiating the process of placing a purchase, additional and unexpected price components (such as taxes, fees and management charges) are added. The literature on the impact of various forms of partitioned pricing suggests

43 Zanjani, G. (2002).
44 Campbell (2011).
45 See footnote 24.

that suppliers can have an incentive to engage in these practices in order to take advantage of consumers, because consumers treat expenses that are presented as being beyond the control of the supplier more forgivingly than other add-ons.[46]

Discussion of price regulation in *takāful* faces an additional complexity due to the role of the TO as manager of the fund potentially able to influence the attribution of income and expenses to the fund. A false distinction could easily be created between the disclosures of an operator that internalises its operations and so has no external 'charges' and one that outsources. In the context of *takāful*, there could be the risk of misattribution of expenses such that one operator might take some expenses to the shareholders' fund and another to the policyholders' risk fund (PRF), but charge a higher *wakālah* fee than one that pushes all expenses through the PRF, disclosing a lower *wakālah* fee and potentially giving a superficially more attractive impression to prospective participants.

The presence of different practices relating to surplus disposition or operator remuneration also poses practical difficulties for any proposal for price regulation.

2.2.4 Distribution and distribution channels

"Distribution" refers to the manner in which products are sold, whether by the insurer/TO directly (through branch offices, a sales force or a website) or via an intermediary, who may be either appointed by the insurer/TO or operating as a professional on their own account. There is diversity in the channels through which the functions of selling, soliciting or negotiating and servicing contracts of insurance and *takāful* are performed both within and across markets.The model of distribution channels adopted in a particular market is influenced by the types of consumer products involved in that market, the types of consumers they serve, and the nature of the service provided (e.g. whether sales are on an "advised" or "execution only" basis).[47]

Intermediaries may play a dual role in the promotion of financial awareness and insurance/*takāful* uptake. They may perform an advisory function to help identify the suitability of products for consumers' needs, as well as a delivery function in procuring

[46] Ott and Andrus (2000); Lefevre and Chapman (2017).
[47] IAIS (2016).

the products. The extent to which the intermediary is involved in determining the actual price paid by the consumer may vary.

An intermediary appointed by the insurer is often referred to as an agent, and an independent professional as a broker or adviser. The distinction can be blurred, and there is a spectrum of possible models ranging from the tied agent, selling only one insurer's products and operating under the responsibility of that insurer, at one end, to the truly independent broker, performing a full market comparison, at the other end. An independent intermediary may have distribution agreements with several insurers, and in some of these cases, the intermediary is selling, to the insurer, access to a customer base it controls. Some jurisdictions however limit intermediation only to prescribed models.

The activities of intermediaries can range from offering simple, non-life/general products to complex products, such as unit-linked life/ family *takāful* products. In addition to specialist intermediaries, intermediation is practised by other commercial businesses such as banks. In many markets, banks have been able to use their existing distribution infrastructure to become an established insurance distribution channel (the 'bancassurance' or 'bancatakāful' model). The bank receives a commission for selling the product, but does not normally determine the terms and conditions of that product. Distribution channels may also involve a variety of partners that are not traditional financial services players, such as car dealerships, post offices, retailers and travel agents acting as intermediaries by offering insurance/*takāful* related to the primary goods and services they sell, at the point of sale. Such sales are often referred to as add-on sales.

Consumer protection concerns arise in distribution due to the risk that distribution practices promote adverse consumer outcomes, perhaps due to conflicting incentives or failure to exercise due skill. The literature identifies such risks in traditional insurance distribution systems where the intermediary or seller has a significant advisory role to play in the sales of insurance and *takāful* products.[48] In these situations, sellers can exert considerable influence on the final product choice made by the consumer.[49] It has been traditional for those selling insurance products, particularly intermediaries but sometimes also direct sales staff, to be remunerated either by a mixture of basic

[48] Diacon and Ennew (1996), pp. 67–80.
[49] ibid; see also Vongsuraphichet, et al (2017); IAIS (2016).

salary and commission or by commission alone. It is observed that, while agency theory would suggest that outcome-based contracts of this nature may be efficient in this type of market, the pressure to sell and the relative ignorance of the consumer mean that there is no assurance that such arrangements will be administered ethically or in the consumer's interest.[50] In a situation where a salesperson will not receive commission unless a product is sold, there is no incentive to advise the consumer against purchasing a product, or to recommend a product on which commission is low as opposed to high, even if such a recommendation would be in the consumer's interest.[51] The risk of conflict of interest is further exacerbated where volume incentives are provided to the salesperson.

The importance of incentives and the tension between the interest of the intermediary (or TO) and the interest of the participants, arising from the commission basis of remunerating sellers (however called) is a proper subject for regulation. The risk of differential rates of commission is not limited to brokers, but can also apply to other intermediaries, for example where an agent holds binding authorities for more than one operator and may be incentivised to offer some business to one operator rather than the other.

The misalignment of interests inherent in *takāful* models is not widely dealt with in the literature to date, though one author has identified that as the greatest risk in the *wakālah* model.[52] The TO manages the participants' risk funds for a fee, but does not bear the consequences of inappropriate or adverse business actions and may have incentives to pursue volume and accept business notwithstanding the interest of either the applicant for cover or the existing policyholders. Whilst the literature identifies this as a particular concern in the *wakālah* model, it may also be said to exist in other models in which the TO similarly acts as manager of the participants' funds but its incentives are not aligned.

Particular reference may be made to examples in conventional insurance of cases where intermediary malpractice has led to adverse consumer outcomes and regulation aimed at avoiding recurrence. Among these, the case of payment protection insurance

[50] See footnote 56.
[51] Similar concerns are identified in the field of consumer credit, in FinCoNet (2016), guidance to supervisors on the setting of standards in the field of sales incentives and responsible lending.
[52] Kassim (2017) in IFSB and World Bank Group (2017) pp. 88.

is well documented (see footnote 33 above). The more general case of insurance sold as an add-on to another purchase[53] has also caused concern. It is argued that products sold in this way are often associated with poor consumer outcomes and ineffective competition.[54] Consumers offered add-on products at the point of sale may be in a poor position to determine their actual needs, the merits of the product offered, and the alternatives available by shopping around. In addition, the person selling the product may have limited knowledge of the product and its merits in order to advise on it, as well as having an incentive to push the product in order to earn commission. The IAIS (2018) identifies online sales as facilitating passive purchases of add-on insurance products.

2.2.4.1 The emergence of new distribution channels

The extended range of distribution channels for the sale of financial services and products, especially through mobile phones and the internet, has benefited consumers. As highlighted in the IAIS's publication, technological advancement has changed consumers' expectations and preferences, and the nature of interactions between consumers and suppliers, and between insurers and intermediaries.[55] As a result, new technologically-driven business models are emerging in area of marketing, distribution and servicing of insurance. So are communication methods, insurers now are making use of online "real time" communication and selling methods including e-mail, internet websites, mobile phone applications and social media.

Although there are benefits to consumers resulting from increasing use of new channels of distribution and new uses of technology to design and distribute insurance products, various form of risks are associated with these channels and techniques, particularly in terms of fraud and in respect of the information provided to consumers. There is a reduction in face to face advice, and potential for an increase in automated advice.[56] The same changes in technology that bring the benefits also give sellers more control over the information that consumers receive. For example, the designer of a website or app has much more control over the process by which consumers

[53] For example, a travel agent may act as an insurance agent for travel insurance, and offer that product alongside the holiday that it is their main business to sell. Another example might be where a consumer purchases electrical goods, and is offered insurance against the risk of breakdown once the manufacturer's warranty has expired (sometimes called 'extended warranty insurance').
[54] Iscenko et al. (2014).
[55] IAIS (2018b).
[56] ibid.

access information.[57] As a result, sellers have more opportunities to misrepresent prices and to frustrate price comparisons. Finding information, assessing its relevance and reliability and analysing it may be particularly challenging for consumers. According to the IAIS, insufficient consumer understanding of the product and provider may present risks to consumer outcomes. Risks may also arise from misuse of consumer data where techniques such as telematics are used.[58]

Price-comparison websites (PCWs) now represent an established component of the distribution system for insurance products in some countries, and an emerging channel in others. In principle, PCWs provide information to customers looking to access the market and to obtain the best deal (though the focus may only be on price). While these websites have the capacity to improve information, studies suggest that their level of information depends on how comprehensive a website is, in terms of its coverage.[59] If a consumer uses only a PCW, the PCW controls the range of suppliers available to that consumer. Issues may arise as to independence and conflicts of interest, for example if a website operator accepts inducements to 'push' particular insurers' products, or fails to cover a reasonable proportion of the market. The Competition and Markets Authority in the UK has also expressed concern as to the impact on price competition, where a PCW restrains an insurer from offering better deals elsewhere (a practice known as 'most favoured nation clauses'), as a condition of including that insurer on the PCW.

Progress in digital commerce and growth of direct online selling of insurance is challenging the adequacy and effectiveness of traditional regulatory and supervisory frameworks for intermediaries, including requirements relating to licensing, disclosure, promotions, marketing and advertising. Supervisors need to adapt their regulatory and supervisory approaches to deal with new and emerging risks. In doing so they face the challenge of balancing the benefits of innovation against the need for consumer protection.[60]

57 Haviid (2013).
58 IAIS (2017).
59 See Footnote 84.
60 IAIS (2016), *loc. cit.*

2.2.5 Promotion

The discussion of advertising/promotion activities in relation to consumer protection typically focuses on unfair business-to-consumer commercial practices. Advertising and promotion fulfil a function of creating outlets for goods and services, and firms rely on them to provide competitive advantage.

Promotion covers a wide range of activities including advertising, sales promotion, publicity, personal selling, telemarketing, direct marketing, illustrations and other methods such as product placement, brand differentiation or the offering of incentives. Promotion activities may affect consumers' perceptions of products and influence their behaviour, for example by making a consumer aware of the existence of a product or provider. The primary purpose of promotion is to induce consumers to purchase a particular product in preference to others, or from one provider in preference to others. Accordingly, practices such as misleading advertising can impair the consumer's ability to make an informed decision, causing the consumer to purchase an inferior product rather than the best product for them in the circumstances. While the persuasiveness or otherwise of promotional literature or sales talk is ultimately down to the supplier, it is recognised as a proper subject for regulation that advertising and other promotional materials should be fair, clear and not misleading.

Restrictions on unfair commercial practices in business-to-consumer interactions in general are widespread. A generic example of regulation imposing restrictions is the European Union's Unfair Commercial Practices Directive.[61] This Directive covers both misleading actions and misleading omissions, as well as aggressive commercial practices, all of which are capable of impairing the ability of a consumer to make an informed decision and hence the consumer's freedom of choice. This Directive is not specific to financial services, and indeed Article 3(9) expressly allows Member States to adopt more restrictive or prescriptive requirements in fields including financial services. More specific Directives and European Regulations have specified particular matters relating to commercial practice in consumer financial markets, including the Insurance Distribution Directive,[62] which establishes information requirements and conduct of business rules for insurers and intermediaries, with additional requirements for insurance-based investment products.

[61] Directive 2005/29/EC Concerning Unfair Business-to-Consumer Commercial Practices. (Article 3(9)).

[62] Directive 2016/97 on insurance distribution (recast).

For much general insurance, future financial performance is of limited relevance (unlike investment-based life insurance products where a consumer could be induced by illustrations to select one product over another). In the context of *takāful* however, promotions may have features even for general insurance where there is a possibility of misleading consumers as to future financial performance through sales illustrations. Some *takāful* operations, including general insurance, adopt the practice of distributing surplus arising in the Participants' Risk Fund (PRF) to policyholders, rather than alternative measures such as retaining it as accumulated reserves of the fund, assigning it to charitable purposes or using it to support future levels of contribution (premium).

Those TUs adopting this approach and making it a selling point need to be aware of the risk of creating expectations, at the point of sale, as to future financial performance. Where the possibility of distribution is promoted as a selling point,expectations of distribution may persist even when there is no surplus, creating customer dissatisfaction, and those sold contracts on an expectation of distribution may feel misled. Whilst warnings accompanying illustrations, and clear disclosure of the present financial condition of the PRF, may mitigate this risk, it is noted that such transparency could have the unintended consequence of adverse selection, if a PRF is in financial deficiency (i.e. is dependent on *qarḍ* to meet capital requirements and absorb losses on a temporary basis).[63] There is also scope for unfairness between consumers participating in the distribution, and between cohorts of policyholders, in the methods that may be adopted for allocating surplus where that practice is present. The question of expectations created by product illustrations at the point of sale is also encountered in a manner more familiar from conventional insurance, where in family *takāful* the TO (in addition to acting as agent for the risk fund) acts agent for the investment fund that represents the savings component of the participant's contract. Expectations as to future performance are critical at the point of contract, and will be informed by information presented by the TO or intermediary. The role of the TO here is not unlike that of an asset manager, for those forms of product where the consumer's main benefit arises from accumulation of investment income in the investment fund.

Assertions in promotions as to Sharīʿah compliance are also potentially important, as they may mislead consumers if transparency is inadequate.

63 Smith J, in IFSB and World Bank Group (2017) pp. 48-49.

These specificities of *takāful* create a rationale for considering regulation of promotion practices and materials.

Evolving technological change facilitates the use of 'behavioural advertising', the practice of tailoring advertising to individual consumers based on the tracking of their online activities and related information captured on the Internet or elsewhere over time.[64] Such advertising is personalised to targeted consumer and may be helpful by filtering out advertising for products and services for which a consumer has no interest, while at the same time providing useful information on the availability, price and characteristics of products that may be of interest. The concept of fair advertising outside traditional channels is increasingly attracting regulatory attention. Notwithstanding these potential advantages, behavioural advertising raises concerns about privacy and the use of personal information. There is also evidence that some firms are failing to provide consumers with adequate information on their transactions, and their rights. There are concerns regarding the extent to which the collection and storage of consumers' personal data for advertising and marketing purposes may undermine consumer privacy.[65] A set of principles to guide the use of behavioural advertisements has been proposed by the OECD. Under the principles, consumers would be informed if data about their activities on a website are to be collected or used by third parties for online behavioural advertising purposes. Consumers would be given the choice as to whether their data would be collected, with the ability to opt out of collection, use or transfer of their data in some cases.[66] Best practices for data security would be required and certain sensitive personal data would be subject to a higher level of protection and consumer control. In many jurisdictions, existing privacy and data protection regulation already impose requirements of this nature.

The UK Office of Fair Trading (OFT) published a market study in 2010 looking at behavioural advertising and the extent to which it may be harmful to consumers shopping online.[67] The study also sought to examine consumer awareness and choice about the kind of advertising they receive. A separate study was conducted in the same year looking at those advertising and pricing techniques that may mislead consumers, as well as price comparison websites (UK OFT, 2011).

64 Price (2016); Chaffey and Smith (2013).
65 Myers (2016) 'Protecting Personal Information'.
66 UK, FCA (2013).
67 UK OFT 1231 (May 2010).

2.3 Approach to Consumer Protection Regulation in the Insurance and *Takāful* Sector

Approaches to regulatory and supervisory measures and practices aimed at enhancing consumer protection in the insurance and *takāful* sector vary between jurisdictions, and continue to evolve. This section describes some major types of consumer protection regulation applied in insurance/*takāful* markets.

Basic consumer protection mechanisms exist in most countries, but the scope and form of regulatory philosophy varies from one country to another, depending on local tradition, culture and practice, and market development. Regulatory approaches can broadly be classfied into two types. A more traditional approach focuses on establishing detailed rules that insurers and intermediaries must adhere to in their dealings with consumers. A second approach centres on establishing principles for market conduct and good faith in dealing with consumers, and requiring insurers and intermediaries to establish internal guidelines and procedures for complying with those principles.[68] In some countries, self regulatory bodies, rather than government established regulatory and supervisory agencies (RSAs), have responsibility for defining and enforcing industry rules. The degree to which they substitute, or complement, the activities of RSAs varies.

A typical regulatory approach to consumer protection by way of conduct of business provides a "toolbox" of measures. Chatterjee identifies typical components of conduct of business regulation as including the monitoring of: (a) compliance with high ethical standards, transparency, including disclosure of different terms and conditions and of charges; (b) honesty and integrity of operators and their employees together with their intermediaries; (c) the level of competence of the operator supplying the products and services; and (d) fair business practices.[69]

In the context of *takāful*, the principles and procedures also include *ex-ante* Sharīʿah compliance of products and services complemented by the *ex-post* attestation of such compliance. IFSB-8 provides that, where appropriate, additional information may be provided on investment policies and practices, such as in the case of unit-linked *takāful* products. Disclosure requirements for investment-type contracts would extend to periodic statements.

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[68] Skipper et al, 2000.
[69] Chatterjee (2009) in Archer et al (eds) p. 85.

An RSA may have available to it a range of available instruments, such as mandatory disclosure requirements, creating appropriate incentives, establishing principles and guidance, monitoring, intervention, sanctions, and redress. In many countries, national law sets a more or less detailed framework of requirements within which RSAs have authority to develop their own rules and guidelines, though the extent to which those are binding on the industry will vary depending on the authority delegated to the RSA. This section provides brief discussion of approaches to disclosure, pricing, suitability, intermediaries, the *takāful*-specific areas of Sharī'ah compliance and *qarḍ*, and general legal protection.

2.3.1 Disclosures

Superficially, mandatory disclosure of relevant information might be thought to be an effective mitigant to the problem of asymmetric information between insurers /TOs or intermediaries and consumers. Disclosure aims to provide consumers with relevant information needed to make informed decisions. Product transparency, disclosure requirements, the use of plain language in insurance and *takāful* contracts are means through which consumers may understand products being offered and to make informed decisions.[70] This is especially true for products (such as family *takāful* products) that involve long-term relationships and infrequent decisions.

However, mandated information provision may not be effective as a remedy if consumers either do not understand the information or do not believe that it is relevant to their decision making.[71] Therefore, the extent and format of the information and the point at which the information has to be delivered to reach the consumer need to be carefully considered. In addition, the effectiveness of disclosure is dependent upon the level of financial literacy within the market. Consumers could be overwhelmed with the quantity of information provided, rendering disclosure ineffective.[72] Any regulation targeting retail markets has therefore to take into consideration consumers' limited skills and capabilities in the processing of information.

Some regulations specify minimum disclosure requirements, in format and content, at the point of contract.[73] The arguments in favour of requirements to disclose specific

[70] See paragraph 74, IAIS (2017).
[71] Liedtke, 2011.
[72] See Footnote 73.
[73] ibid.

information in standard form include the following: (a) it eases comparison between alternative products; (b) standardised information can help consumers make choices; and (c) the consumer is often uncertain about what is relevant information to demand when complex products are involved. Mandatory disclosure requirements set out minimum disclosure requirements on a consistent and standardised basis that all firms must adhere to for all retail customers. This does not preclude additional information being provided.[74]

It is sometimes argued that it is in the interest of operators and intermediaries in a competitve market to disclose relevant information to consumers in an open manner and that they will therefore do so without compulsion. There is, however, evidence from the UK that investment and insurance companies have strongly resisted disclosure of their costs, which meant that consumers were unaware of the full costs of financial products (e.g. life assurance, and personal pensions). It is not necessarily to be expected, therefore, that firms would voluntarily disclose information as it might encourage competition on price, rather than non-price, and firms may prefer the latter.

Huck and Inderst (2010) present a 3-stage framework on how consumers interact with the supply side in well-functioning markets, the three stages being the following: (a) access information about the various offers available in the market; (b) assess these offers in a well-reasoned way; (c) act on this information and analysis by purchasing the product or service that offers the best value. The study has however shown that firms on the supply side may go a step further and seek to take advantage of consumer biases in the forms of conduct, in each of the three stages, which certainly can harm consumers.[75] Examples at each of the three stages are as follows:

a. *Accessing information*: Firms can make it more difficult for consumers to perform searches. Because consumers do not always look at pricing terms that are not provided up front, firms may exploit this by putting more of the price into add-on services, adding clauses, or making searching harder using drip pricing.
b. *Assessing offers*: Firms can make it more difficult for consumers to assess which is the best deal. As consumers can find it difficult to compare differently structured offers, firms may exploit this by making their prices less clear, increasing the number of options, or raising the degree of

[74] Llewellyn, 1999.
[75] Huck and Inderst (2010); Lefevre *et al*, (2017).

complexity. They may also use price promotions and framing to distort decision-making.

c. *Acting on information and analysis*: Firms can make it more difficult for consumers to act to get the best deals. Consumers may display more inertia than traditionally thought, perhaps due to overconfidence in their capacity to improve their situation later.

Regulation through disclosure requirements is consistent with the information-based rationale for consumer protection (that disclosure increases market transparency and reduces transactions costs). Economic theory points to disclosure as the most direct solution for information failures and it is widely promoted as a part of consumer protection measures, including in the IFSB Standard IFSB-9. However, some observers argue that the complexity of insurance products and potential for services to consumers varying across consumers and over time creates difficulty in the effective use of disclosures. As was commented on in section 2.2, behavioural economics suggests weaknesses in the consumer decision-making process. Realising this, many countries have both strengthened their disclosure requirements and sought to improve the effectiveness of consumers in the marketplace through consumer education.[76] IFSB-9 recommends, through the illustrative example of a long-term endowment family *takāful* plan[77] that a supplier proposing a *takāful* product to a consumer be required to give a detailed explanation of the features, and ensure that the consumer understood the contract properly before committing to the policy. Other relevant requirements (also recommended by IFSB-9) include a mandated 'cooling-off' period (within which the policyholder may withdraw from the contract), enabling the purchase decision to be revisited.[78]

Some have also promoted an outcomes-based approach, whereby the supplier is deemed to have assumed some responsibility for ensuring suitability, such that any consumer contract is treated as though it were advised.[79] Suitability and appropriateness testing then forms a significant aspect of the consumer journey, requiring consumer due diligence. Such requirements typically exempt much general insurance/*takāful* business, but place emphasis on advice where the consumer is making a comparatively large or infrequent transaction, such as life insurance or family *takāful* with an investment component.

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76 Financial Consumer Protection Principles, OECD, 2014; Atkinson et al. 2015.
77 See paragraph 44, page 12, IFSB-9.
78 48 of 73 countries surveyed by the IAIS had such a requirement (IAIS, 2010).
79 See BCBS, The Joint Forum (2008) pp.16.

As was touched on above, even in the absence of malpractice or negligence on the part of the TO or intermediary some aspects particularly of investment-based Family *takāful* products may not be readily assessable at the point of contract. The policyholder has an interest in how the investments will be managed, and as to how they will perform, neither of which may be susceptible to informed assessment.

In some jurisdictions, regulation provides for supervisory approval of sales illustrations and promotion materials before they may be used,[80] though in others the responsibility is placed on the Board or other governing body to ensure that promotional materials are fair, clear and not misleading and otherwise compliant with prescribed requirements, and regulation provides for punishment if that duty is not observed. Regulation aims at preventing exaggeration of facts and inaccurate aims, and to ensure that consumers are given sufficient warning of the risks associated with various products.

Regulation of disclosure at point of sale may also not be adequate to manage risks relating to claims handling, in which the policyholder has an interest but which may not be readily assessable at point of sale.

2.3.1.1 Post-sale service disclosures

Consumers require on-going information to enable them to monitor the performance of the product or service and whether it continues to meet their needs and expectations. It also important that providers communicate in a timely manner, on their own initiative as well as in response to transactions or enquiries, events affecting the consumer's interest in the product, such as a change in the contract terms or condition (if the supplier can change these unilaterally), or any important event and its implication for the consumer. IFSB-8 recommends that, where appropriate, additional information be provided on investment policies and practices, such as in the case of unit-linked *takāful* products. Disclosures that meets consumer needs can facilitate transparency and effective service delivery. Disclosure requirements for investment-type contracts would extend to periodic statements, for which IFSB-8 also makes recommendations.

2.3.2 Product oversight

The IAIS Application Paper identifies product oversight by the RSA as an important component of conduct of business supervision in the insurance sector. This term covers a range of different supervisory tools and processes aimed at ensuring that

[80] For example, Hong Kong's requirements for investment-linked insurance products.

consumers are treated fairly by insurers in all phases of an insurance product's lifecycle.[81] According to the paper, the approach and process to be adopted should be determined by evaluating risks and mitigating factors in the light of regulatory objectives.[82]

At the point of introduction of a product to the market, RSAs have broadly three different approaches to adopt: (a) a principles based approach; (b) a file and use approach; and (c) a prior approval approach.[83] Different combinations of these approaches are used in different jurisdictions, depending on policymakers' perceptions of the level of vulnerability of the consumer, the complexity of the product, the capabilities and resources of the supervisor and the impact on innovation, as well as local preferences as to market intervention.

A pre-approval approach is used more in jurisdictions where insurers and intermediaries have limited technical skills, distribution channels are new and outside the control of the supervisory authority and consumers have low financial knowledge. According to a survey included in the IAIS Application Paper,[84] supervisors in emerging countries commonly adopt a pre-approval approach for more complex consumer products and a file and use approach for simpler ones.[85] In this way, RSAs adopting this approach exercise control over contract provisions and the pricing of products. Whilst this approach conveys more legal certainty to stakeholders (consumers, providers and intermediaries) as there is a formal decision,[86] it may hinder development of new products and distribution channels, and the ability of providers to respond to environmental factors (for example, changes in longevity) in product design and pricing. It may also place unrealistic demands on the technical skills and resources of RSAs relying upon this approach. By contrast, RSAs in a more mature insurance market commonly adopt a more principles based approach, setting higher-level requirements and requiring firms to establish their own detailed policies and processes to deliver compliance with those requirements. In EU countries, for example, the responsibility for governance of product development rests with the governing bodies of the insurers concerned, with RSAs supervising the quality of the design and

81 See IAIS (2017).
82 Paragraph 121, footnote 80.
83 See paragraph 130, footnote 80.
84 See Country examples in paragraph 136, footnote 81.
85 ibid.
86 See paragraph 137, pp.41 footnote 81.

effectiveness of compliance and monitoring the market rather than intervening in products.

So far as concerns price regulation, direct regulation of insurance product prices has become less common, notably in the EU due to a belief that market discipline can be effective in the insurance market, and recognition of the efficiency costs of restricting competitive market forces. It is in fact generally impermissible for insurance premium rates to be prescribed in the EU, where the market has been opened to cross-border competition.[87] However Tennyson comments that disclosure requirements are most stringent in those jurisdictions that have liberalised pricing. For some other jurisdictions, including the US and Canada, direct regulation of insurance prices and products remains a general feature of the insurance market. The focus is on policy forms where the products are subject to regulatory prior approval. Regulation of pricing is mostly through requiring prior approval of rates introduced by firms or indirect premium regulation. Indirect premiums regulation may take the form of regulating insurers' risk classification practices or by limiting expense charges.[88]

Even where a principles-based approach is adopted, RSAs typically still adopt minimum disclosure standards, including standardised formats for disclosures about the product. The standardised format can take the form of a "Key Information Document" or similarly-named document, setting out the product's key features, facilitating understanding of the policy by both the consumer and the seller. Regulation may also disallow specific clauses or practices, or override default aspects of contract law, that are deemed generically unfair.

RSAs subsequently monitor the use of products, considering whether in practice products are used as designed, or looking for evidence of emerging problems or consumer detriment by techniques such as complaint analysis and thematic studies.

[87] The current articulation of this prohibition is Article 21 of Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009, but it dates from 1994 when the single market in insurance became effective.

[88] Tennyson in Liedtke et al. 2011, p200

2.3.3 Intermediation

Supervisory approaches to intermediation vary. In some jurisdictions, the same RSA is responsible for supervising intermediaries and insurers, but in others, different authorities supervise intermediaries and insurers. Some jurisdictions adopt the 'twin peaks' model where prudential and conduct supervision are conducted in different authorities across broader range of products than only insurance.[89]

Some jurisdictions require intermediaries to be licensed but some apply indirect supervision, via self-regulatory organisations, or (in the case of tied agents selling one insurer's products) via the insurer itself. Licensing for intermediaries allows supervisors to set and supervise conduct standards, at the point of entry into the market, and on an ongoing basis.[90] In many jurisdictions, there is a a considerable number of intermediaries operating which creates logistical challenges for supervisors.

The supervision of intermediaries may be performed by an institution other than the RSA, for example, by professional associations acting as self-regulatory organisations; [91] this can mean a lower cost of supervision and a more manageable workload for the RSA but at an enhanced risk of market failure. However, even where intermediaries are licensed, it follows from the risk-based basis of insurer supervision espoused in IAIS ICPs and in IFSB-14 on risk management in *takāful* that an insurer or TO should still exercise proper management over risks to it arising from its use of intermediaries. Thus, the moral hazard of reliance on the separate authorisation of the intermediary is mitigated, provided that the insurer's or TO's observance of its risk management requirements is conscientious and is supervised by the RSA.

The potential for conflicts of interest was identified in Section 2 as a significant issue in relation to intermediaries and their remuneration. Sales-based remuneration of the intermediary (or even of the sales person) can constitute a significant element of the price of an insurance contract, and the commission basis of selling has attracted attention, with disclosure of commission one potential form of regulatory constraint to mitigate conflict of interest. Some independent advisers charge fees for advice on investment-linked products and this is now the norm in some jurisdictions, for example the UK[92] and Australia, both of which banned commission payments for financial

89 See paragraph 28, footnote 94.
90 See Section 3.3. Licensing and licensing requirements, footnote 94.
91 See IAIS (2016) survey paragraph 23-25.
92 FCA (2016).

advisers in 2013, in favour of a fee-for-advice model. It does not however extend typically to general insurance, and commission remains a staple element of intermediary remuneration in many jurisdictions. Volume commission rates for agents and brokers are outlawed in some countries, however, regulators also have to be alert to the possibility of intermediaries being remunerated by operators in other ways than by commission, triggering a possible conflict of interest in that way.

As an example of recently adopted regulation on the principles-based model, the EU Insurance Distribution Directive which came into force in 2018 includes requirements that insurance intermediaries will act honestly, fairly and professionally in accordance with the best interests of their customers.[93] Consumers are required to be provided with clear information about the intermediary's professional status, its range of insurance products, and basis (though not necessarily the amount) of remuneration which it will receive. The intermediary should disclose whether it is independent or working under an exclusivity agreement with an insurer. Particular disclosure requirements apply in respect of insurance-based investment products, where the level of charges can affect the amount of funds invested and the return on investment.[94]

The emergence of digital commerce, and the increasing use of direct online selling of insurance by insurers and intermediaries, have led to questions about the adequacy and effectiveness of traditional regulatory and supervisory frameworks, including requirements relating to licensing, disclosure, promotions, marketing and advertising. The development of distance marketing and 'platforms' facilitating consumer comparison of competing offerings has led some RSAs to examine potential abuses and develop regulations, for example the UK ban on price comparison websites giving 'most-favoured nation' status to insurers allowing their product to be included on the website, whereby the insurer undertakes not to offer the same product at a lower price elsewhere.

Insurance 'add-ons' have been a particular focus of some regulators. For example, the UK Financial Conduct Authority has performed its own market studies and developed expectations as to good practice, including banning opt-out selling and requiring improvement of information provided to consumers early in the sales journey. Lefevre and Chapman also survey some regulators' approaches to add-ons.

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93 Directive 2016/97.

94 See IAIS (2016) paragraph 119-122, "*Managing conflicts of interest through disclosure*" & paragraph 123-130 "*Approaches to remuneration*".

2.3.4 Takāful specific regulation

This section considers approaches to issues that are specific to *takāful* as opposed to conventional insurance.

2.3.4.1 TO as agent

The agency problem is an inherent feature of *takāful* models based on the *wakālah* and *muḍārabah* business models. Earlier sections discussed approaches to mitigating the detrimental effects that the agency problem can cause (incentive alignment, licensing, disclosure, governance and so on), though it is not possible to identify definitively effective solutions. A country may specify mandatory *takāful* business models, to facilitate comparability for both supervisors and customers and avoid the complexity of multiple models in the market. Malaysia has specified a 'Takaful Operational Framework' that it requires TOs to apply, which obliges them to establish and apply detailed procedures for the management of the business.

2.3.4.2 Qarḍ

Internal segregation of funds is a typical feature of *takāful* undertakings. Although each fund has its obligations and potential risk affecting the position of the fund, the shareholders' fund may be used to provide capital support to the policyholders' fund, by way of provision of *qarḍ*. Disclosure to actual and prospective policyholders may be required to include information on the financial condition of the fund, though firms may have concern that disclosure that a fund has *qarḍ* to repay could act as a disincentive to enter a *takāful* contract, potentially accelerating its financial failure, to the detriment of existing policyholders. Prudential supervision is outside the scope of this paper, but where a PRF has *qarḍ* to repay, a policyholder may be aggrieved if induced to join it by promises of profit distribution. However whilst a rationale exists for regulation of this area, conventional insurance offers few examples on which policymakers might draw as the concept of a loan to a fund that is in deficit, to be repaid out of future surplus attributable to policyholders, is rare in conventional insurance.

2.3.4.3 Surplus Distribution

Distribution of surplus back to participants is used in some markets as a marketing attraction for *takāful,* as the participants are promised a portion of the surplus emerging in the fund, assuming there to be a surplus. Allowing the TO also to receive a share of

the surplus may assist in alignment of incentives, however not all markets allow the TO to share in the surplus.

As has been noted in Section 2, the promise of distribution of surplus may create expectations in potential policyholders, that cannot then be met if in fact no surplus is earned, and a policyholder could as noted be aggrieved if in fact future surplus is already earmarked as the fund has *qarḍ* to repay first. These matters may be addressed in regulatory approaches to disclosure and promotion, and obligations to consider the fair treatment of customers (see above).

Section 2 also noted the risk of unfair treatment at the time a distribution of surplus is made, depending on the method adopted or prescribed. Alternative approaches to surpluses could be used to avoid this issue, such as retention in the fund as capital, use to smooth future volatility, loyalty discount, or devotion to charitable purposes. In the conventional insurance industry, some types of life insurance (with-profits or participating business) can also generate surpluses whose disposition is problematic if some policyholders are not to be treated unfairly. Regulation typically limits the uses to which such accumulated funds may be put and imposes governance constraints (for example, the UK's requirement at COBS 20.2 in the FCA Handbook for independent oversight of reattribution of accumulated but unattributed surpluses).

2.3.4.4 Sharīʿah compliance issues

All *takāful* products require Sharīʿah compliance, although the products are open to both Muslims and non-Muslims. Consumers seeking assurance of Sharīʿah compliance have to consider the reliability of the assertions of TOs concerning Sharīʿah compliance of their products and operations.

Not all RSAs have a mandate to enforce Sharīʿah compliance, though even those that do not may regard assertions of Sharīʿah compliance as a conduct issue and require TOs to have policies and procedures in place to manage this risk effectively. Typical objectives 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 Sharīʿah compliance of its contracts and operations. As an example, the Takāful Operational Framework applicable in Malaysia requires TOs to ensure operation in accordance with Sharīʿah.

Accordingly, a TO may be required to have an effective governance framework in place provide assurance that the products and operations of the undertaking are consistent

with Sharīʿah at all stages of engagement with consumers, and so support the reliability of the assertions of TOs for consumers seeking assurance of Sharīʿah compliance of their products and operations.

The claim of Sharīʿah compliance raises potential risks regarding the suitability of products and other related issues, particularly where there may be different understandings of Sharīʿah 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 Sharīʿah authority whose rulings the Sharīʿah committees of all TOs must observe. Requirements for pre-approval of contracts, where these exist, will not necessarily mitigate the risk as the RSA examining the contract may not consider the risk of divergent understanding. Governance framework requirements such as those referred to above would need to address this risk where it exists.IFSB standards on conduct of business for institutions offering Islamic financial services (IFSB-9) and guiding principles on governance for *takāful* undertakings (IFSB-8) offer guidance, illustrative examples and recommended practices for institutions, both generic to Islamic financial services and specifically applicable to the *takāful* sector. IFSB pronouncements on *takāful* emphasise the fiduciary role of the management of a *takāful* undertaking, in the absence of mechanisms for policyholders to monitor performance and protect their own interests. Accordingly, regulators require appropriate and effective governance structures requiring TOs to protect the interests of policyholders against other competing interests.

2.3.5 General legal protection

Consumers fall within the scope of general legal protections governing contracts, and may also have rights to seek redress under laws, both generic and specific to insurance or *takāful*. The different remedies available vary between countries and from sector to sector.

Whilst legal action is a possible form of redress, regulation typically requires insurers and intermediaries to have effective processes for the receipt and assessment of complaints, and for those processes to be made clear to the policyholder as the first avenue for redress when they believe they have been treated unfairly by the insurer or an intermediary, so reducing the need for policyholders to resort to law.

Complaints handling processes are typically required to deal with complaints fairly and effectively, and within a reasonable time, both to provide redress when appropriate and to ensure that the firm analyses the complaint and identifies any weaknesses in its procedures that need to be addressed. Reporting of complaints data to the RSA enables the supervisor to assess the level of complaints and the efficiency of the firm in dealing with them, and identify for further supervisory investigation particular firms or issues that seem to generate frequent or serious complaints.

A legal system that can possibly award compensation to policyholders, in a timely and efficient manner, provides insurers and TOs with added incentives to engage in fair and efficient business practices, particularly in areas such as claims settlement. In addition to regulatory requirements that may govern complaints handling, insurers including TOs and intermediaries are generally within the scope of civil law governing unfair, misleading or deceptive practices of sellers, aimed at providing consumers with confidence that insurance contracts will be honoured. Where a complaint is not resolved satisfactorily through a firm's complaint handling processes, private lawsuits remain a possible avenue for the consumer to seek redress from an insurer or TO who has failed to perform a contract or who has otherwise acted unfairly. In addition to compensation for loss suffered, some jurisdictions provide for punitive or exemplary damages in egregious cases. However, resort to private lawsuit is generally costly, can be protracted, and may be beyond the reach of individual policyholders. Some jurisdictions permit 'class actions' enabling consumers to approach the courts jointly.

In order to provide additional protection to consumers who may not have ready recourse to the courts, in many countries a financial services or insurance ombudsman office (within or separated from the regulator) operates to adjudicate consumer disputes with insurance or *takāful* companies.[95] Although systems differ across countries, ombudsman programmes generally operate only where a policyholder has sought and failed to obtain satisfaction through a firm's own complaint handling process. An important aspect of an ombudsman's role in mediating disputes between insurers, TOs or intermediaries and consumers is that the ombudsman is legally empowered to bind insurers, TOs and intermediaries by its decisions. The ombudsman scheme thus, in those countries where it exists, forms part of a hierarchy of dispute resolution and protects consumers from the costs of pursuing private lawsuit.

It is common for countries have specific laws or regulations regarding insurance or *takāful* contracts, in which the rights and responsibilities of insurers or *takāful* operators

[95] AIDA, Turkey 2014 (Alternative Dispute Resolution Systems Regarding Private Insurance).

under the contracts are delineated. However, the extent to which these provisions provide additional protections to policyholders under the contracts varies, and they may not in all cases create a right of private action.

SECTION 3: SURVEY RESULTS: RESPONSES FROM REGULATORY AND SUPERVISORY AUTHORITIES

3.1 Introduction

This and the following section record survey findings on consumer protection regulation in the *takāful* sector. The survey was conducted by the IFSB Secretariat between March and June 2018, with two sections covering, respectively, regulatory and supervisory authorities and *takāful* operators. The questionnaires aimed to collect information on regulatory practices on consumer protection in the *takāful* sector with a focus on conduct of business practices including determination of product suitability and other requirements aimed at preventing mis-selling and identification and mitigation of conflicts of interest. This section provides the analysis on RSAs, and Section 4 the analysis on TOs.

So far the survey of RSAs is concerned, responses were received from 11 RSAs, from the following jurisdictions: the nations of Bahrain, Brunei Darussalam, Kazakhstan, Malaysia, the Maldives, Nigeria, Pakistan, Saudi Arabia and the United Arab Emirates; and two designated financial centres, being the Dubai International Financial Centre and the Qatar Financial Centre.

3.2 Regulatory and Supervisory Requirements

Ten of 11 RSAs responding to the survey reported that they have a mandate for consumer protection, specified in the legislation or other instruments establishing the supervisory architecture.

The approaches to consumer protection vary by jurisdiction, although they have common elements. In each jurisdiction, the supervisory framework for consumer protection is set out in the relevant law.

For each supervisory regime, laws and other regulatory requirements require adherence to good practices or codes of conduct and prohibit poor practice or unfair treatment. They also require supervisors to monitor and intervene in cases of abuse or improper, detrimental or unfair conduct.

Eight of 11 RSAs also reported that they include, as part of the supervisory objectives specific to *takāful*, compliance with Sharī'ah.

3.3 Product Development Oversight

All 11 respondents reported that the regulations and guidelines in their jurisdictions require TOs to take customer interests into account in the development of *takāful* products. Respondents adopt different approaches to product development oversight, nine applying a more principles-based approach focusing on desired output, and two being more prescriptive as to requirements. Respondents reported that they pay particular attention to product development prior to the launching of a new product, with a view to ensuring fair treatment of the customer. Consideration is given to the following three elements: (a) relevance of covered risks to the target market; (b) Appropriate terms and conditions for the target customers; and (c) appropriate pricing and structure of premium/contribution payment to suit the paying capacity of the customer.

In response to a question on supervisory monitoring of TOs at the development stage of products and services, all 11 respondents indicated that consumers' interests form a major part of their supervisory objectives, but through different approaches. Approaches ranged from pre-approving products to reviewing and monitoring the *takāful* operator's own product development process, and intervention when deemed necessary.

Those two RSAs reporting that product design must proceed within prescribed boundaries provided examples with a focus on terms of contracts to ensure that information given to the retail consumer is clear, correct, and not likely to mislead. Requirements include mandatory contract terms, and prohibition of other contract terms. These might relate to consumer rights, language of the contract, specification of pricing and costs, among other examples. RSAs reported that their framework addresses the product design and pricing philosophy, profit expectations for new products offered, appropriate assessment and mitigation of risks of product, and compliance with Sharī'ah principles during the product development and marketing stage.[96]

[96] See BNM (2014), Policy document on "*Introduction of New Products by Insurers and Takāful Operators*"

Regulation may require TOs to: (a) establish an approval process that give considerations particularly, to retail customers; (b) establish clear approval process for marketing materials associated with new products; and (c) organise training for marketing personnel and/or intermediaries to facilitate understanding of the product's features and customers' rights especially in respect of the suitability and appropriateness of the product.

Five of the 11 respondents required TOs to obtain pre-approval of each product before it is launched on the market. According to respondents, product approval is to ensure that the operators comply with supervisory requirements, particularly on product features and product disclosure material, and to enable the RSA to ascertain whether the TO has considered the interests of its intended customers in the product development process.

Product oversight varied by product line, as did supervisory practices regarding the pre-approval process. Two main approaches were identified. One, which might be described as "file and use" was reported mainly for general *takāful* products. A second, more intensive pre-approval scrutiny, was reported more for family *takāful* products.

3.4 Compliance with Sharī'ah Principles

Five RSAs required new product proposals to pass through two levels of Sharī'ah scrutiny, the Sharī'ah board of the TO and a separate Sharī'ah supervisory committee appointed by the supervisor. Other respondents indicated that only the Sharī'ah board review was required.

One RSA required the Sharī'ah board of the TO to apply AAOIFI Standards on Governance (Governance Standard for Islamic Financial Institutions No 2) to assess the TO's Sharī'ah compliance. Five RSAs required TOs to submit product documents for verification by the Sharī'ah supervisory committee appointed by the supervisor.

Two respondents stated that the prescribed product approval process does not include checking for compliance with Sharī'ah principles.

3.5 Suitability Determination

Nine of the 11 respondents reported the existence of regulatory provisions on suitability determination, requiring salespersons and intermediaries to conduct proper suitability assessment on products that have an investment element and are long-term in nature. These also provide typically that before customers make their final commitment to

enter into a *takāful* contract, the TO must provide the customer with full details of the cost of the product.

Nine of the 11 respondents stated that the TO is responsible for ensuring that products developed and marketed are appropriate to the needs, resources and financial capability of the target consumer segments. Suitability for a segment of customers is considered at the product development stage. Suitability for individual consumers is assessed at the point of sale through need and financial analysis. After sale call back confirmations were also used to validate the assessment. Some respondents referred to assessment tools that could be provided for consumers to conduct self-assessments of product suitability against their own profiles, to estimate the amount of coverage needed and to gauge the affordability of the product based on current income, expenditure and financial obligations.

All respondent RSAs reported disclosure requirements prior to the sale of a *takāful* contract. TOs (or their representatives) and intermediaries are required to obtain from the customer the necessary information to identify the customer's circumstances and objectives.

Two respondent RSAs referred to guiding principles, and more than two-thirds referred to detailed guidelines, on proper advice practices aimed at improving the quality of advice provided to the consumers. According to these respondents, their supervisory focus in this regard is to strengthen expectations for insurers and TOs to conduct sufficient enquiries to understand consumers' financial needs and priorities, particularly for family *takāful*.

Respondents reported that both TOs and intermediaries have responsibility for determination of suitability of products prior to recommending a sale. Some jurisdictions further specified that for family *takāful* products with substantial investment characteristics, the TO itself must determine suitability.

Only five respondents required intermediaries to disclose conflicts of interest that may affect the advice they may provide to consumers.

Respondents reported that the depth of consideration of suitability may depend on the type of products. For compulsory products, such as third party motor liability product, the explanation of the product's suitability may be limited to a brief explanation of the obligation to hold such a product, and the options available to satisfy the obligation.

The six RSAs who responded to a question on verification requirements did not generally require the supplier to verify the information provided by the customer as to stated needs.

3.5.1 Record-keeping Requirements Relating to Suitability Determination

Six respondent RSAs reported that suppliers must keep records of information provided to customers as well as any other activities undertaken within the framework of the suitability determination. These RSAs require *takāful* operators to document advice given in line with the suitability requirements, and the basis for that advice. These respondents require use of a prescribed format to document the advice ('Customer Fact-Find' and Need Analysis Form).

One RSA required the issue of a 'Confirmation of Advice' to the policyholder together with the *takāful* certificate. The Confirmation of Advice contains a summary of the fact-find, product recommendation and key features of the product.

3.6 Disclosure Requirements on Sales and Distribution

The majority of respondents report that supervision of disclosures focuses on ensuring the fair treatment of customers, both at the point of sale and through to the point at which all obligations under a contract have been satisfied. This embraces disclosure of sufficient, accurate, clear and not misleading information to help consumers make informed decisions. These set requirements include timing, delivery and content of information provided to customers at the point of sale. The guide and promotional materials provided to customers at this stage should contain sufficient information on key features of the product such as a benefits illustration and associated risks, and should not obscure important statements or warnings, such as exclusions, so that customers can make well-informed decisions about the purchase of the *takāful* product.

Two-thirds of the respondents also referred to other channels through which information can be disclosed to customers, including advertisements and promotions as well as pre-sale, point- of- sale information and post-sale information. The respondents expressed the opinion that the customer's ability to make a well-informed decision is dependent upon the kind of information available to them through various disclosure channels.

Two RSAs mentioned lists of disclosure requirements specific to family *takāful* and investment-linked family *takāful* products. Seven other RSAs considered that disclosure requirements applicable to conventional insurers and insurance intermediaries covered the necessary requirements for *takāful*.

Four RSAs required the use of a standardised disclosure format for product features and illustrations.

Some respondents laid additional emphasis on the disclosure of any possible conflicts of interest of direct sales staff and intermediaries involved in the distribution of *takāful* products

More than half of respondents considered that monitoring the post-sale policies and procedures of TOs is an important aspect of their supervision. Post-sale supervisory review may include monitoring the effectiveness of a TO's own controls to monitor the quality of ongoing post-sale policy servicing and information disclosures.

The majority of respondents reported that they had rules requiring TOs to provide the customer with clear information about the performance of their business.

Four RSAs require TOs to comply with relevant AAOIFI standards, in particular, Standard 13 (Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies).

On whether the TO is responsible for the action or omission of its agents, five respondents reported that this was the case.

3.6.1. Communication with clients/advertisements

Eight respondents reported that they review all marketing, promotion and advertisement materials prior to their first use, and can require TOs to modify that information. Similarly, more than half of respondents indicated that action had been taken on "plain language" guidelines.

Two respondents emphasised that guidelines on communication with customers and advertisements set principles rather than prescriptive rules.
Four respondents reported that the TO's Sharī'ah advisers must review all marketing and communication materials prior to their first use. One respondent required an additional endorsement from its own Sharī'ah supervisory committee.

3.7 Sales Programme Requirements

3.7.1. Intermediaries

Responses indicated that the approach to intermediaries varies significantly from one jurisdiction to another.

Two-thirds of respondents have direct responsibility to supervise intermediaries and set licensing requirements for them. Three RSAs indicated that the responsibility is shared between the supervisors and a self-regulatory organisation (SRO), with the SRO involved in monitoring intermediaries' activities but the RSAs retain primary supervisory responsibility. However, two RSAs are not directly involved in regulating the activities of *takāful* intermediaries. In these cases, SROs establish rules for the registration and regulation of *takāful* intermediaries and to require professionalism and good business conduct. The RSA reviews the rules prior to issuance.

Those RSAs that delegate the supervisory function to SROs saw this as a way to enable supervision of a high number of intermediaries in the market, allowing the RSAs to concentrate on other monitoring activities.

Ten respondents reported identification and management of conflicts of interest and related risks as a significant supervisory focus. Supervisory requirements address remuneration, quality of advice, appropriate disclosure and timing of delivery, and appropriateness of communication and advertising to customers. According to the survey responses, intermediaries' practices are subject to enforceable supervisory standards through different approaches ranging from direct supervision by the supervisors to requiring the TOs to monitor the activities of their own intermediaries closely through various means.

The survey also asked how RSAs were adapting traditional regulatory and supervisory frameworks to cater for changing models for insurance distribution, such as price comparison websites. Few RSAs reported changes being made. According to one respondent, the priority is to ensure that the customer ultimately knows where to turn in the event of a claim or complaint, or for information or advice. The nature of the distribution chain was not seen as having a detrimental impact on fair outcomes for customers. This view may be at variance with observations of IAIS research.

One RSA (Pakistan) reported that it maintained a register of agents found to have been involved in misconduct, which family *takāful* operators were required to consult before appointing a person as agent.

Those respondents directly supervising intermediaries' activities added that compliance and complaints departments of TOs are sources of information gathering, particularly, on consumer complaints and sales patterns. To some extent, monitoring consumer complaints and sales patterns is also used to identify specific conduct issues and market-wide misconduct.

3.7.2. Handling Customers' Money

Monies held by an intermediary can come from the TO through claims or refunded payments and/or from the customer for payment of premiums.The questionnaire asked about requirements relating to the handling of customers' money, with a view to exploring the approach to the risk of lapse due to intermediaries delaying or failing to pass on premium (contribution) funds to the TO. Where cover is contingent on the TO receiving the money, the customer is exposed to this risk.

All but two respondents confirmed that their supervisory guidelines covered customers' money held by intermediaries. These requirements provided that premiums/contributions are deemed to have been paid to the TO as soon as the intermediary receives and acknowledges the payment, and conversely that claims are only considered paid to the customer when paid on by the intermediary. Thus, the TO bore the risk of money in the intermediaries' hands. In one case however intermediaries were forbidden to handle contributions for Family *takāful* participating with profit policies, and policyholders were required to pay the contribution directly to the TO.

However, guidelines reported by some respondents appeared to provide exceptions to this general practice, if an intermediary was not authorised by the TO to receive money on its behalf but accepted it nonetheless. In addition, one respondent reported that while this was not the case for payment made to *takāful* brokers and financial advisers, since they do not represent the TOs, customers' interests were protected in the event of misappropriation of contributions by mandatory professional indemnity insurance of such intermediaries.

All but two respondents required *takāful* intermediaries to hold customers' money separately in segregated accounts with licensed banks. According to the RSAs, the

rule aimed to ensure proper protection of client money, and to prevent the commingling of customers' money with intermediary assets.

In all cases, respondents emphasised the requirement for adequate financial controls and records-keeping and traceability of customers' money. Some jurisdictions set time limits on the payment of customers' money.

3.7.3. "Cooling Off" or "Free Look" Period

All respondents reported that their jurisdiction operated a period during which the customer is free to cancel the policy and to have his or her premium reimbursed. This period according to the supervisory guidelines of the respondents, varies from 14 days to 21 days. In one case, the ability to cancel was contingent on the policyholder having an objection to a term or condition of the contract.

3.8 Supervisory Monitoring and Specific Actions

Policies and procedures on supervisory monitoring of conduct of business matters vary from one jurisdiction to another. Three approaches are identified, being thematic review, on-site inspections and off-site inspections. Supervisors use a combination of these approaches.

Eight respondents recognised thematic review as a part of the supervisory toolkit.

All respondents required periodic reporting from TOs and (where directly supervised) intermediaries, covering information relevant to supervision of conduct of business. Reports mentioned included financial reports and reports on types of products sold, business partners, remuneration, claims, complaints, and general compliance with licensing or other requirements. RSAs also referred to the value of information including data from or exchanges with industry associations, industry or general media, and other related agencies.

Three respondents referred also to monitoring of advertisement material and modes of advertising and to the value of monitoring in detecting non-compliance, and in identifying changes in business practices and the development of new products. According to these respondents, these activities contribute to a better understanding of the market and market trends, and can help in detecting emerging conduct risks at an early stage.

Eight respondents reported the performance of on-site inspections as part of their supervisory toolkits for suitability assessment of TOs and/or intermediaries on a continuous basis. Those RSAs that supervise intermediaries directly explained that on-site inspection of intermediaries often follows a risk-based approach, due to the significant numbers of intermediaries to supervise.

Three respondents reported review of suitabilitity assessment processes as part of their standard on-site inspection processes. Others considered this more on a basis of risk, and referred to their ability to examine this (or any) area on an ad-hoc basis if problems were identified.

Respondents reported different practices regarding supervisory measures against different forms of non-compliance. Measures reported included both corrective and preventative actions, taking a variety of forms including directions to address an issue, penalties, redress and ultimately, restriction or withdrawal of licence. Some respondents emphasised the importance of proportionality, and the need for due process including right of appeal.

3.8.1. Non-Compliance with Sharī'ah Provisions

Four respondents expected TOs and intermediaries to demonstrate a strong compliance culture, in the interest of all market participants. This was expressed as a principle. These four respondents reported that if a product promoted by a TO was determined not to be Sharī'ah- compliant after it has been sold, the TO would be directed to promptly rectify the situation in the most effective way and to explain the reason(s) for the failure. According to one respondent, the TO would be required to amend the product and have it re-reviewed and approved by its Sharī'ah board and by the RSA and, depending on the circumstances, to redress customers.

3.9 Complaints Handling & Settlements

Two respondents did not provide comments under this heading. The remaining nine respondents reported that alternative dispute resolution mechanisms (arbitration forums or an "ombudsman") have been established for customers to seek redress to settle individual disputes, or to mediate claims. Respondents provided different examples of bases for referral to such a mechanism and in particular violation of rules on sales practice. These jurisdictions require *takāful* undertakings to establish

adequate procedures for handling customer complaints and to join an alternative dispute resolution body.

3.9.1 Customer complaints handling

Ten respondents reported specific requirements regarding maintenance of procedures for the recording and handling of customer complaints by TOs and intermediaries, and for reporting complaints data to the RSA. Requirements reported by respondents included time limits for responding to complaints, and internal and supervisory reporting requirements on root causes of complaints and remediation action required to address those root causes.

Some respondents emphasised the importance of complaints data as a source of market intelligence and assistance in gauging the quality of a TO's or intermediary's market practices.

3.9.2 Claims management

Seven RSAs reported that their point-of-sale disclosure requirements included informing the customer of the claims process under their policy, and of their rights in that process. Seven respondents emphasised that ultimate accountability for the correctness and fairness of claim outcomes remains with the TO. One reported that where intermediaries handled claims, profit-sharing-type arrangements with the TO were prohibited because of the conflict of interest this created with the customer.

3.10 The Emergence of New Distribution Channels

Only four respondents commented on supervisory guidelines relating to emerging distribution channels such as price comparison websites/aggregators. These RSAs have licensed price comparison website/aggregators, and one respondent stated that they are currently operating under what is sometimes referred to as a "regulatory sandbox" framework for financial technology (fintech) solutions, whereby experimentation is permitted for innovative services or products, providing an opportunity for the RSA to assess the risks involved. Another respondent commented that these activities already fell within an existing activity requiring licensing.

The respondents observed that rapid growth in digital commerce is changing customer expectations, preferences, and the nature of TO and intermediary interactions with customers. This has also led to emerging issues such as the adequacy and

effectiveness of traditional regulatory and supervisory frameworks and in particular requirements relating to licensing, disclosure, promotions, marketing and advertising. Respondents mentioned requirements that TOs and intermediaries should observe, for example providing FAQ sections and maintaining cyber-security.

3.11 Consumer Education Programmes

The majority of respondents reported that they have consumer education programmes, but the approach towards financial education varies considerably. Most reported that their focus is on improving the financial literacy of consumers, particularly the awareness of the importance of *takāful* products in long-term financial planning and security. None compel *takāful* undertakings and intermediaries to promote or engage in specific customer education.

Many respondents have a dedicated unit responsible for promoting financial literacy and financial inclusion with activities such as organising lectures, seminars, and workshops for various target audiences. However, not all supervisors have a formal mandate for promoting better insurance awareness for the public. In some jurisdictions, the role may be assigned to a different organisation. For example in Bahrain, the Bahrain Insurance Association takes this responsibility.

SECTION 4: SURVEY RESULTS: INSIGHTS FROM MARKET PLAYERS

An important object of the survey was to explore practices with regards to TOs' engagement with consumers at different stages from product design to sales, claims handling and settlements. This discussion includes the activities aimed at meeting suitability obligations and avoiding mis-selling.

The questionnaire provided to TOs covered the following areas, and this section is organised accordingly:

a. products and services offered

b. market and development of new products

c. information collected from the customer at the point of sale

d. forms of disclosures to be made to the consumers

e. scope of suitability assessment

f. compliance (policy concerning the sales intermediaries, and advertisements and marketing)

g. dispute handling and settlements mechanism

4.1 Composition of the Takāful Operators Surveyed

Twenty-nine *takāful* operators responded to the survey.

The table below presents the composition of *takāful* operators who responded to the survey.

Table 1: Sample Composition of the Takāful Operators

S/N	Country	Number of *Takāful* Operators for Each Country
1	Saudi Arabia	5
2	Pakistan	15
3	Malaysia	8
4	Sudan	1
	Total	**29**

The business activities of *takāful* operators in the sample could be categorised into three forms: general *takāful*, family *takāful*, and composite. Fourteen operators are predominantly operating general business,11 operate family business and four operate composite business. Each operator presents the practice regarding its conduct of business and protection of consumers' interests.

4.2 Products and Services Offered

The range of products and services offered by *takāful* operators differs, depending on the business segments. The general *takāful* business comprises of seven major business classes (see Chart 1). The dominant business class in all countries in the sample is motor, possibly due to its mandatory coverage. Because of its short-term characteristics, which require it to be renewed periodically, it is also less risky (from the point of view of the consumer) compared with family *takāful* products which have long-term savings and investment features. Family *takāful* business consists of four key business classes (see Chart 2), but the profile varies considerably with different emphasis on protection only products, on savings products, on health and on credit-related products. The significant proportion of retail network of consumers further illustrates the role of sales intermediaries in the distribution of *takāful* products.

Chart 1: Components of General Takāful Business by Country

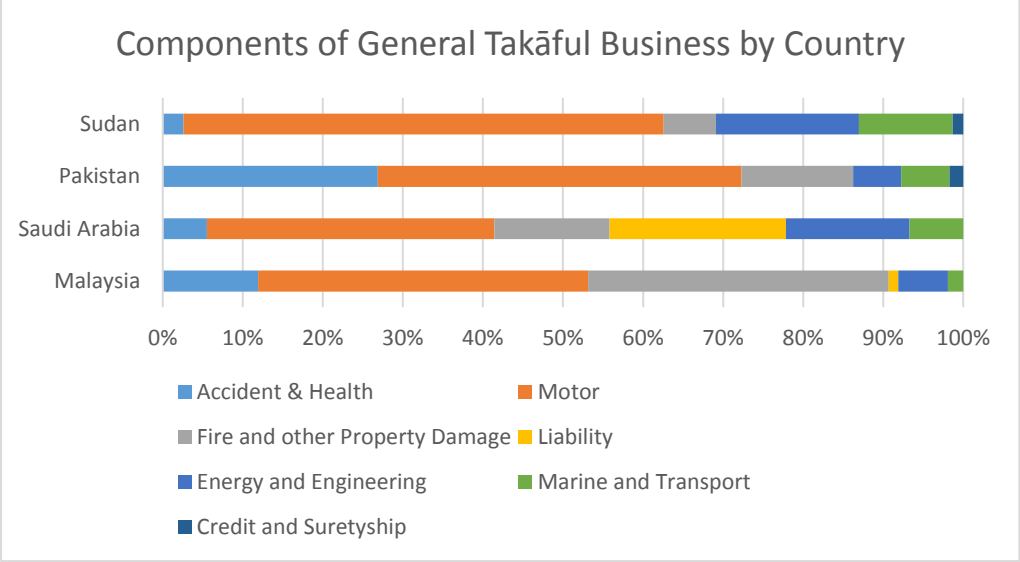
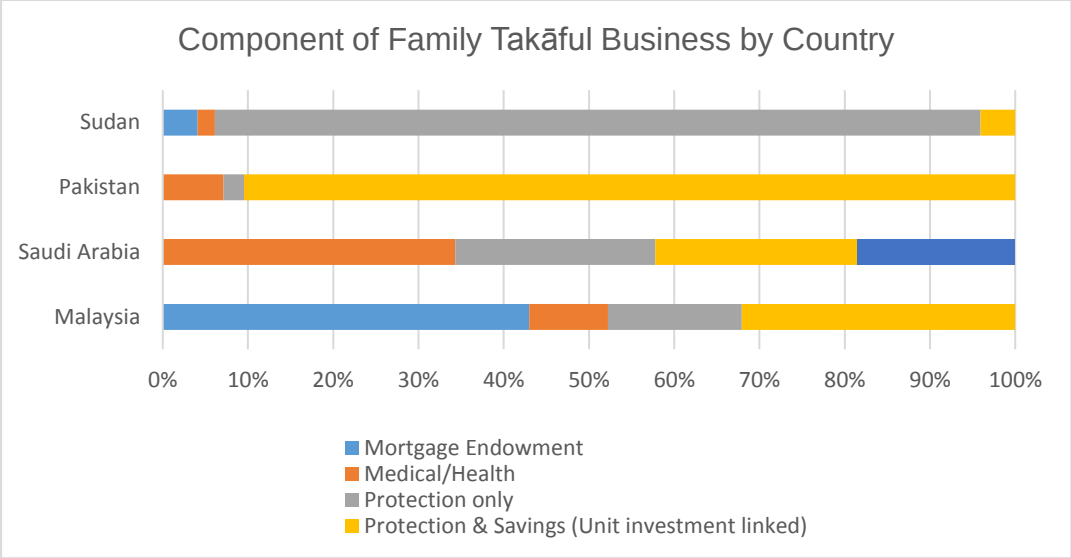


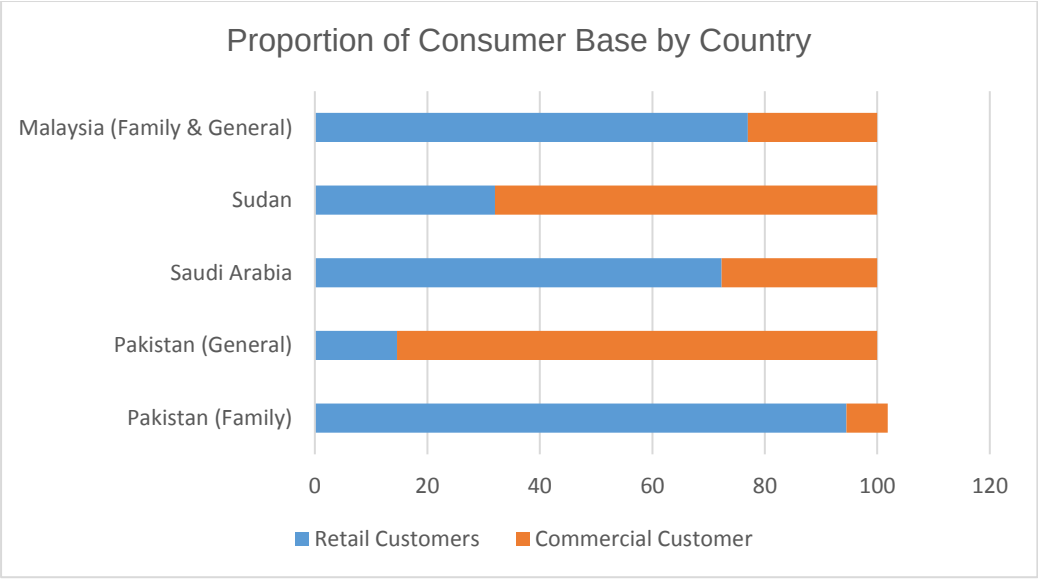
Chart 2: Component of Family Takāful Business by Country



4.3 Retail versus Commercial Business

The data suggest that family business is dominated by retail business, more than general (see chart 3), however the information is insufficiently granular to permit clear conclusion. Group family products are typically classified under commercial customers.

Chart 3: Proportion of Consumer Base by Country



4.4 Product Development

The product development process varies among the *takāful* operators who responded to the survey. Almost all respondents referred to regulatory requirements governing this area, aimed at suitability for consumers. As indicated by the respondents, prescribed procedures appear to be more restrictive for *takāful* operators dealing with retail family *takāful* products than those mainly concerned with general *takāful* products.

Although, different terminology and nomenclatures were used by *takāful* operators to describe the phases of the product developments process, the survey identified four main phases in the development process common to most of them. These phases are (a) product design, pricing; risk assessment and product management philosophy; (b) product and system Implementation; (c) product submission and approval stage and (d) product monitoring and review. The technical team (sometimes referred to as a product development committee) are responsible for the first two phases. Their responsibilities include preparing the 'product document' to be reviewed by the firm's board of directors and the Sharī'ah board.

Respondents reported that product design and pricing is focused on adequate and reasonable pricing, competitive with products from other key operators. Eighteen respondents emphasised the need to ensure that the product design is coherent with the needs of the targeted customer segments. Statistical data accumulated from customer history are used, together with other sources of business intelligence.

Repondents referred to the need to assess the paying capacity of the target market through marketing research. Product design and pricing is based on market segmentation, and is tested along the distribution channel on the affordability and financial suitability of the target market.

However, six respondents who are mainly concerned with general *takāful* products do not include affordability among the factors considered in designing products, some saying they sell generic products that are available in the market.

Respondents reported different levels of review and approval requirement, ranging from 'launch and file' to more rigorous requirements (Thirteen respondents reported a requirement for supervisory pre-approval). However, the launch and file system is only applicable for long-term products such as family *takāful* products. Nine TOs reported that their supervisor requires supplementary Sharī'ah reviews and approval from the central Sharī'ah supervisory board appointed by the supervisor, but others do not

require such approval. Rather, the supevisor relies on the prior judgement and approval granted by the *takāful* undertaking's Sharī'ah board.

Virtually all the respondents mentioned that they are required to communicate any changes in the terms and conditions of existing policy, products or contract to the affected customer. Three respondents cited in particular the case of re-pricing of individual medical products and group policies.

Those respondents dealing mostly with long-term products such as family *takāful* products acknowledged the inclusion of the "cooling off" or "free look" period clause in the policy's contract terms and conditions. Depending on the jurisdiction, the period varies between two and four weeks from the date of acknowledgment of the issuance of the contract certificate.

Most operators with general *takāful* business report that their products are not covered by cooling-off requirements.

4.5 Disclosure Requirements Concerning Takāful Products

Respondents described point-of-sale disclosure requirements as including the following, though individual respondents' descriptions varied:

a. product characteristics;

b. investment risk;

c. recommended investment duration;

d. expected performance or kind of events affecting performance;

e. information on commissions, fees and other costs borne directly by the customer (thereafter referred to as "direct costs");

f. information on embedded costs borne indirectly by the customer (thereafter "indirect costs");

g. the amount and structure of other remuneration received by the firm for the sale ("other remuneration"); and

h. any conflicts of interest.

The information items are provided in product documents such as product brochure and benefits illustrations detailing the key features of the product such as eligibility, term of membership, plan benefit, allocations, contributions and charges.

Twenty-three out of 29 respondents referred to a prescribed format for product disclosure, provided for by regualtion, highlighting a summary of the important terms and conditions of the product, product benefits, exclusions, fees and charges. The relevant Sharīʿah concepts that spelt out the contract relationship between the participants in the *takāful* fund and the *takāful* operator managing the *takāful* funds are also included in the document. Additional information provided in the document includes the practices regarding surplus distribution policy of the product, allocation of contribution to PIF and/or PRF and past performance of these funds. Four respondents mentioned annual disclosure, again in a prescribed form, particularly for family *takāful* products and other related products such as investment-linked products. Twenty respondents stated that some disclosures were not mandatory but had to be provided to the participant upon request.

Eight respondents stated that information about *qarḍ* is included in the product disclosure materials provided during the contractual stage. *Qarḍ* was not relevant to the model of six respondents. Fifteen respondents (from the same jurisdiction) reported that no specific information regarding *qarḍ* is required to be provided to the participant before the *takāful* policy is sold. What is required prior to sales is for intermediaries or sales staff to describe all the features and terms and conditions of the contract. Some respondents commented that information about the position and movement of *qarḍ* is available in the financial statements that are published quarterly and annually. The customer service department can also assist new customers in understanding the details.

Almost all the respondents emphasised that contract wording is guided by the plain language requirements of the supervisor, for easy understanding by an average customer. Regarding the language itself, contract documents are prepared in different languages understood by customers. Two-thirds of the respondents provide an online version for all the materials needed at the point of sales in an interactive form with the option to select the preferred language.

Two-thirds of the respondents stated that they call the potential customer to explain and clarify the terms and conditions before signing the contract, and call back to check that the customer understood the contract terms and conditions.

More than one-third of the respondents do not involve intermediaries in the distribution of the *takāful* products, but almost all those that do use intermediaries provide compliance training to the sales agents, to ensure that they are aware of the required sales process including disclosure requirements. Ten respondents, mostly family

takāful operators, stated that all intermediaries must undergo product training, and training in the proper way to conduct sales before they can be allowed to distribute the products. Five respondents mentioned compliance with Sharī'ah guidelines among the list of issues covered in the training program.

Many respondents referred to controls that they operate to ensure compliance with disclosure requirements on the part of intermediaries, including requiring intermediaries to give undertakings to follow the company standards and procedures, and performing compliance monitoring of the activities of the intermediaries. The obligations of the intermediary may be set out in a Service Level Agreement/ Corporate General Agreement or Distribution Agreement, and disclosure may be ensured by requiring the use of a call script with clear declaration.

Some respondents do not provide compliance training to sales agents and brokers as they only deal with commercial customers.

Respondents were asked whether the amount of remuneration allowed to intermediaries is independent from the product, and whether it depends on compliance. Quite a number of operators apply both measures.

4.6 Suitability Determination

Eighteen out of 29 respondents acknowledged the need for adequate information as a pre-requisite for proper assessment of suitability of a particular product to the customer. Family *takāful* operators seek more information on personal details such as annual income, occupation, family status, age, and family circumstances including number of dependents; investment preferences and risk tolerance, and financial needs and objectives; and addressing also requirements relating to anti-money laundering and combating the financing of terrorism.

Respondents used different methods to collect customer data. Forms are widely used, sometimes prescribed by the supervisor. More than half of the respondents referred to online interactive forms available on their website.

More than half of the respondents explain that the assessment of customer's need is based on the information provided during fact finding. Five respondents specified that they ask the customer to sign the form to confirm agreement.

The practice as regards providing a formal statement of advice varies among the respondents. Most respondents who are family *takāful* operators noted that the comprehensive statements and confirmations of advice embedded in the forms upon

which suitability assessment and recommendation is made are shared with the customers. These forms contain a section on customer declaration, stating that the product concerned is suitable for the customer. A copy of the statement of advice is attached as part of the Certificate contract documents.

The majority of respondents (23 out of 29 respondents) utilise intermediaries in the sales of their products. In most cases, the number of intermediaries distributing products and services of a takaful operator is high, and sometimes the intermediaries may distribute the products of more than one operator. The requirements of the intermediary to meet suitability obligations may differ from one operator to another, and often, it depends on the jurisdictional supervisory requirements. All the respondents require the intermediaries to demonstrate their competence based on their knowledge and experience.

4.7 Distribution

Twenty-three out of 29 respondents use agents for the distribution of the product instead of, or in addition to, in-house sales staff. Respondents described the use of training programmes designed for the intermediaries and for direct staff, to give them the right orientation on professional responsibilities to the satisfaction of the customers. Respondents indicated they use different practices to ensure that intermediaries maintain the required knowledge and skill to properly conduct the sales process. For example, eight out 23 respondents using intermediaries require their agents to be licensed by the regulatory authority, a process that requires passing a prescribed examination. Licensed agents must attend product training and a refresher course via e-learning and classroom training as the case may be. Not all respondents reported training for intermediaries on demonstration of Sharī'ah compliance of the products.

Other reported measures for ensuring the fitness and propriety of agents included provision of technical support, due diligence and provisions in the agency agreement.

Six respondents reported that they mainly use direct staff who operate from the branches to distribute the products and these are hired by following set procedures. For example, the prospective staff must pass a stipulated examination, after which extensive training is provided. Regular training sessions, symposiums, and e-learning tools are organised to enhance the capabilities and competencies of the sales force especially for staff that distribute protection and saving products.

Almost all respondents report that prior to the launching of their products, the acquisition costs are scrutinised by the supervisor. Seven respondents reported that the commission level is subject to a regulatory cap, set when the product document is submitted for supervisory approval during product design and development before it is launched to the public.

Twenty-three respondents reported that acquisition costs, being part of the *wakālah* fee and various deductions and charges (including unallocated contribution), are included in the product documentation marketing material filed with the supervisor for scrutiny prior to the launching of the product to the public. However, the *wakālah* fee and charges are not subjected to regulatory caps, other than general requirements to be transparent, reasonable and appropriate based on the distribution and maintenance expenses, and required profit margin commensurate with the associated risks. Fifteen respondents reported that in their country acquisition costs are capped only in the aggregate, not at a policy level.

Eleven respondents who deal with general *takāful* products stated that they are not required to disclose their acquisition costs to the potential customer, whereas 12 respondents who deal mostly with family *takāful* products confirmed that such disclosure is part of the pre-contractual process with their customers. They further stated that distribution or acquisition cost is not charged to the policyholders' *takāful* fund.

Respondents reported that, in the case of intermediary error or fraud against the customer/participant, the respondents have a ranges of measures to address the issue. Proper due diligence and imposition of codes of conduct aim to prevent error or fraud, with internal audit as a check, and some respondents limit the extent to which intermediaries may handle cash. Respondents also monitor complaints, and conduct mystery shopping and similar exercises to check compliance.

More than half of the respondents who use intermediaries provide a Customer Self-Service Portal on their website for customers to view their certificate status and verify the validity of their agent with the company. According to those respondent who use direct staff to distribute their products, controlled delegated authority is given to them, but with constant monitoring and feedback from the customers through call-backs. For bancatakāful, most of the contributions are paid directly to the TO.

Eighteen respondents made available additional channels to enquire further about the product (e.g. telemarketing, call centre and website links) and at the same time for

monitoring activities, providing avenues for customers to register complaints with the company or even directly with the regulator.

4.8 Takāful Undertaking Communication with Customers/Advertisements

Each of the respondents has established a standard operating procedure for approval of advertisements and other client communications, including any Sharī'ah approval. The channel of communication varies from one respondent to another.

Twelve respondents, mostly dealing with the family *takāful* product, reported that it they require all consumer-facing documents and advertisements to have Sharī'ah board approval. Six respondents stated that approvals for some items/documents are delegated to the internal Sharī'ah department. Eight respondents stated that regulatory approval is only required for new product advertisement/ communication documents, and particularly for family *takāful*, but not for existing generic and old product campaigns.

Five respondents, mostly family *takāful*, reported that the issuance of any advertisements and client communications (client collateral) related to family *takāful* products are subject to a regulatory pre-approval process together with all the product documentation. For Sharī'ah compliant products, all advertising and client communication is being shared with the Sharī'ah compliance team for review before rolling out the final communication. Marketing materials (at the time of product approval only) and public announcements are subject to approval.

4.9 Privacy and Data Protection

The majority of respondents reported that they have policies and procedure for defining staff roles and limiting access to the customer information system. Staff access to data in each system is based on the user's work-related requirements and controlled by limit of authority assigned by the management. More than half of the respondents require staff and agents to subscribe to confidentiality clauses.

Fourteen respondents confirmed that training and awareness programmes are organised (e.g. an e-learning course on the jurisdiction's personal data protection legislation) for staff to understand the confidential nature and sensitivity of customer data.

Those respondents who used intermediaries reported the use of systematic checks to monitor intermediaries' sales performance and identify any confidentiality concerns, with further investigation if there is any complaint.

Only five respondents provide training and awareness programmes to agents on policyholder privacy.

4.10 Claims Settlement and Complaints Handling

Respondents reported similar processes for claims settlement to ensure fair treatment, and that all claims decisions are made in line with the policy terms and conditions, and the assessment/recommendations of independent surveyors on the regulator's approved panel.

Regarding complaints, each respondent reported that it had a dedicated department with a standard and transparent settlement process for handling complaints. Respondents reported various regulatory deadlines for responding to complaints.

A few respondents indicated that the available channels of seeking redress are sometimes categorised according to the claim amount.

Those respondents who utilise the services of intermediaries reported that training and refresher courses are organised periodically, for intermediaries including bancatakāful partners distributing *takāful* products, and that claim processing procedures and all options for resolving disputes are communicated to them during the training. Ongoing supervision, including monitoring of customer complaints is used to observe the quality of the service provided by the intermediaries.

SECTION 5: CHALLENGES IN CONSUMER PROTECTION FOR *TAKĀFUL*

5.1 Introduction

This section sets out a number of challenges specific to the *takāful* sector, following consideration of the review of the literature and regulatory approaches in Section 2, and having regard also to the survey results in Sections 3 and 4. It is the intention that this discussion informs future decisions of the IFSB as to standard development.

5.2 The Diverse Nature of Approaches to Consumer Protection

Consumer protection regulation and supervision (so far as it concerns conduct of insurance business) follows different structural models in different countries, and any standard development needs to provide sufficient flexibility for RSAs to apply the guidance within the context of their own institutional structure. The survey suggests that the great majority of the 11 respondent takaful RSAs operate prudential and conduct supervision in a single institution. However other models exist (e.g. in the UK and Australia, in both of which prudential supervision and conduct supervision are assigned to different institutions).

There is also a variety of approaches to this aspect of consumer protection. Again, any standard development needs to provide sufficient flexibility for RSAs to apply the guidance within the context of the high-level approach adopted in their jurisdiction. A spectrum exists, which could be simplistically described as ranging from control of products at one end, to freedom of product but strong disclosure requirements and responsibility for suitability assessment, at the other. Different stages of development of markets and differences in sophistication of consumers, in particular countries or market segments may provide justification for one or other approach or a combination (with different requirements for different types of business). ICP 19 on conduct of business recognises this in setting its requirement for 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.

The degree of regulatory engagement in the monitoring and enforcement of conduct requirements also varies, with a historical willingness to allow the industry to keep its own house in order, by the use of self-regualtory organisations, voluntary codes of

conduct and similar devices. Direct supervision by the RSA has, however, become the more usual model, and the self-regulatory organisation model is now less used.

Different approaches are also taken to the regulation of intermediaries, some countries imposing licensing and supervision requirements on them, some relying on self-regulatory organisations, and some making the insurer responsible for the conduct of its tied agents rather than requiring those to be licensed. Again, there is no simple and single approach that all should adopt ICP 18 on intermediaries recognises the need for a proportionate approach, but does lean towards RSA enforcement of standards for intermediaries, whether direct or indirect.

The diverse nature of conduct of business supervision, including of intermediaries, has therefore to be allowed for in considering standards that could be drawn up for *takāful*.

It must also be asked, whether specificities of *takāful* can be readily identified relevant to each of the issues in conduct of business identified in this paper, or whether those issues are generic to insurance? The IFSB may nonetheless feel that the needs of jurisdictions with *takāful* business, and the difficulty of providing guidance only for *takāful* where standards for conventional insurance are not consistent, justify the production of guidance that in essence is applicable to the insurance sector generally. It does not seem inappropriate that, if conduct of business regulation is generally less developed in some countries, the lead in addressing issues facing both conventional and *takāful* business should come from the *takāful* sector where ethical business practice is at the core.

We turn to the challenges identified in this research paper, adopting the headings used in section 2.2 (asymmetry of information; product quality; price; distribution; and promotion) and considering specificities of takaful informed by the preceding materials in this paper. A final comment is provided on supervisory review of conduct of business.

5.3 Asymmetry of Information

Takāful has several characteristics that would tend to exacerbate the asymmetry of information between the consumer and the TO or intermediary. The contract itself is inherently complex, involving cashflows within the provider that the TO may be in a position to manipulate to its advantage, and that require additional explanation to policyholders. Prudential supervision, which is outside the scope of this paper, addresses the risk of inability of a *takāful* undertaking to pay its debts as they fall due.

However family *takāful* in particular requires the policyholder to consider, when contemplating the purchase of a product, the future performance of the product, and this is affected by the detail of the contract, and in particular the remuneration to be drawn by the TO and intermediaries. Some forms of conventional life insurance similarly require the policyholder to consider future performance, and regulations from conventional insurance on disclosure of expenses in contract documentation may be suitable to inform development of similar disclosure requirements for *takāful*, showing the impact in illustrations of the various fees taken.

Sharīʿah compliance distinguishes *takāful* from conventional insurance, and here asymmetry of information manifests itself in a more qualitative way. The policyholder relies upon the producer's assertion that the business model itself is Sharīʿah-compliant, that the product being offered is not offensive to Sharīʿah, and that the TO and intermediary, if any, are acting objectively and in good faith, with a view to the interest of the consumer rather than any conflicting interest that they may have. Existing IFSB standards address questions of Sharīʿah governance, and seek to address information asymmetry by recommending disclosure. However, as IFSB-8 comments, "many of the disclosures … will not be understood by the vast majority of *takāful* participants."[97] In addition, as the analysis in section 2.2 has observed, policyholders may not act rationally even when provided with information, which suggests that disclosure alone is not an adequate mitigant for risk.

Moreover, where disclosure requirements exist, compliance can be low. The survey results from RSAs suggest that market practices can deviate significantly from supervisory expectations, particularly as regards incentives that may constitute conflict of interest, and as regards the soundness of the *takāful* funds into which the policy is written. Poor disclosure practices among some market operators suggest a potential reputation risk and threat to consumer trust and confidence in the market.

The risks arising from asymmetry of information are, it would appear, at least as acute for *takāful* as for conventional insurance, with the added complication of the specific structure of *takāful* contracts under different models, the additional principal-agent relationship arising from the role of the TO, and the dimension of Sharīʿah compliance. The need for objectivity of advice, and identification and avoidance or effective management of conflicts of interest, requires a high degree of competence and integrity among those dealing with consumers, monitoring and enforcement of

[97] IFSB (2009a), paragraph 76.

compliance with standards designed to achieve this end, and redress where a *takāful* consumer has been unfairly treated. The IFSB may consider how such mechanisms may be recommended to supervisors.

In recognition of the fact that policyholders can be overwhelmed with information and misinformed by the presentation of that information, many jurisdictions now require a simple disclosure document containing prescribed information in a prescribed form. This is more frequently the case for products containing an investment element, though the practice is also applied commonly to general insurance. Policymakers will need to ensure that additional information prescribed to cater for the specificities of *takāful* does not make such documents unwieldy and so defeat their purpose.

The analysis provided does not suggest that supervision and enforcement of disclosure is necessarily sufficient to mitigate information asymmetry. Policymakers could consider whether disclosure requirements can be complemented by consumer education on finance including *takāful*, delivered through financial institutions or by some other means, and the IFSB could provide guidance to RSAs in this regard.

Existing IFSB standards and guidelines on matters relevant to consumer protection in Islamic finance more broadly include IFSB-4 on Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services; IFSB–6 on Governance of Islamic Collective Investment Schemes; and IFSB-9 on Conduct of Business Standards.

5.4 Product Quality Characteristics

The analysis indicates that qualitative characteristics of products may be difficult to ascertain, and consumers may be ill-equipped to determine whether or not the product offered to them is appropriate for the purpose for which cover is sought. Some regulators therefore place the responsibility on the provider (or intermediary, if the sale is intermediated) to make an assessment of whether the cover is suitable for the policyholder. That does not just mean checking that the cover provides what the policyholder wants, but also that the contract is appropriate to the circumstances of the policyholder (does not, for example, provide cover - at a cost to the policyholder - that the policyholder could never use) and responds to the policyholder's preferences as to risk and term. This last point is particularly important in the case of family *takāful*, where the product represents a significant provision of the policyholder for patrimony or for retirement income, that could be frustrated if the investment strategy is too risky or if earnings are swallowed up by poorly disclosed fees.

The survey results indicate that some surveyed jurisdictions require filing of *takāful* products before they may be marketed. Supervisors require approval particularly for family *takāful* products. It can be argued that supervisory pre-approval of product documents provides a check against the distribution of inappropriate products; however once the supervisor has approved a product, it may be difficult to correct a problem that only becomes apparent later, and it may also be said that supervisory approval implicates the RSA in any defects perceived by the consumer. Also, requirements for pre-approval may stifle innovation.

A key element of quality for *takāful* business, distinguishing it from conventional insurance, is Sharīʻah compliance. Not all RSAs will have the mandate or the ability to monitor compliance, but claims to Sharīʻah compliance are a matter of ethical conduct that the RSA should at least review to ensure that they have a basis. Existing IFSB standards provide guidance in this area, but a standard on conduct of business would need to encompass supervision of Sharīʻah conduct.

The balancing of the risks on product quality represents a conundrum for policymakers. As noted above, policymakers may take different approaches to the supervision of quality of products, some intervening by requiring pre-approval, others requiring evidence of product governance, including Sharīʻah governance, and assessment of suitability to match the quality of the product to the needs of the customer. A more interventionist approach may be possible if products are standardised and consumers and sales forces unsophisticated, but may be less beneficial where consumers seek bespoke products. The survey results suggest that RSAs of *takāful* lean towards requiring suitability assessment to be performed both at the point of product development (by reference to the target customer base) as a part of the governance process for development and maintenance of products, and at the point of sale. The IFSB may consider the development of standards recommending this as a default approach, with recommendations as to the criteria by which policymakers should consider not requiring it. Standards may also recommend good practices for the performance of suitability testing - for example, the use of scripts, recording of calls, documented advice and acknowledgement.

5.5 Price

Pricing in *takāful* generally raises similar concerns to conventional insurance, in terms of the need to ensure fair treatment of consumers.

Seeking to influence consumer decisions by “price framing” could be prohibited, and disclosure of costs charged out of the premium (contribution) by way of commission,

wakālah and other expenses, can be mandated, to inform the policyholder how much of the premium is credited to the fund out of which claims are to be paid, or (in particular) the fund which is to be invested for the policyholder's benefit or held to guard against the community's risk. In *takāful*, the sometimes complicated structure of charges can make it difficult for a policyholder to compare two potential products, and create possibilities for misleading presentation.

The IFSB may also wish to consider the possibility of issuing guidance on the impact of technology, in view of developing techniques for market segmentation and pricing. The IAIS has identified risks of exclusion from insurance of those who represent poorer risks (who can in this way be "priced out" to improve the quality of the risk pool) or are simply less tech savvy and unable to use technological resources to conduct business. Regulators may be called upon to consider whether exclusion, whether or not intended, is compatible with the principle of solidarity underlying *takāful*.

Price as a focal point has led to the development of price comparison websites, enabling consumers to compare potential suppliers using a single metric. The RSA's responsibilities in respect of price-comparison websites can be discussed by the IFSB in standards development.

5.6 Distribution

Takāful business is sold to consumers through different channels, including direct, and the IFSB may feel that the protection that the consumer receives against unethical or incompetent conduct should be the same regardless of the channel of distribution, and hence that the standards should apply to all those who are customer-facing.

It may be felt that *takāful* does not have extensive specificities so far as concerns the distribution of the product, compared to conventional insurance. However, the IFSB may wish to consider recommending particular practices - in particular, recommending to RSAs that salespersons and intermediaries of all types be permitted to distribute *takāful* products only when they have been assessed as competent to advise customers on *takāful* of the type in question, including as to the Sharī'ah-compliance features of the product.

Where a jurisdiction makes use of self-regualtory organisations to monitor and enforce conduct of business rules, the IFSB may wish to encourage its members to take an active role by bringing conduct of business supervision clearly within the ambit of the

regulator, establishing a licensing regime for intermediaries and applying fitness and propriety requirements.

The use of intermediaries raises particular concerns as to the potential for conflicts of interest, as the intermediary is typically remunerated by the producer and there is scope for the intermediary to seek to maximise its own benefit rather than pursue the consumer's best interest. Some jurisdictions do not allow the payment of commission for some products - in particular, family *takāful* - requiring financial advice to be paid for by the consumer explicitly rather than through commissions charged to the insurer by the intermediary. A ban on commissions earned by intermediaries may be felt impracticable or premature, as likely to result in withdrawal of advised services for populations who need advice. However mechanisms such as requiring disclosure of commission, and prohibiting volume-based commissions (whereby bonus commission rates are paid for higher volumes of business) could be considered. Inducements for intermediaries may also be restricted.

Regulation of intermediaries has also to consider the question of the status of moneys paid by the consumer and not yet paid to the TO, or by the TO but not yet paid to the consumer. The survey results suggest that while in general the risk for money in the hands of the intermediary rests with the TO, this is not always the case.

The survey indicates that a "free look" period is a common requirement for much investment-based family *takāful*. This practice could be recommended as a mitigant against pressure selling of long-term products.

The question of whether operations of intermediaries, as opposed to just the contracts that they intermediate, should be required to be Sharīʿah-compliant is not considered to be within the scope of this paper, though concerns have been expressed by respondents where conventional financial institutions distribute *takāful* products.

5.7 Promotion

Promotion of *takāful* business can be seen as having certain specificities justifying additional regulatory constraints compared to conventional insurance. The need for substantiation of claims as to Sharīʿah compliance is mentioned above. Where a product is marketed on the basis that the policyholder benefits from underwriting surplus sharing, additional concerns arise.

Guidance may be helpful to RSAs in developing requirements for underwriting surplus sharing and *qarḍ* repayment. This is to address the risk of new policyholders being

unfairly induced by inappropriate communications into becoming members of a fund that has an unpaid *qarḍ* obligation, considering the information needed by the customer at the point of sale and thereafter.

A tension may also exist between surplus sharing methods adopted, and the fairness of customer treatment. IFSB standards development may assist the development of consensus on how surplus should be distributed to policyholders.

5.8 Supervisory review

Supervisory review in *takāful* and *retakāful* is the topic of an IFSB standard currently under development. The variety of different approaches to conduct of business in both conventional insurance and *takāful*, which affect the scope of their responsibilities, renders it difficult to recommend detailed model review procedures for RSAs.

The IFSB may nonetheless wish to provide guidance to RSAs on principles for supervisory review activity, including regulatory reporting (e.g. of complaints data), offsite and onsite monitoring related to conduct requirements, thematic review and ad hoc activities such as mystery shopping, as well as ensuring that reviews of governance and risk management include conduct risk within their scope.

ANNEXURE: EXAMPLE REGULATORY PRACTICES ON CONSUMER PROTECTION

The template presented below is derived from recommended or observed practices from a number of national and international statutes and regulations.

General

(i) The legislative framework should set consumer protection objectives and responsibilities regarding conduct of business regarding *takāful* products and services, and provide a clear definition of the scope of consumer protection mechanisms.

(ii) The institutional structure should provide for regulatory and supervisory authorities with a mandate, authority and resources to make, supervise and enforce (whether directly or indirectly) conduct of business requirements for *takāful* undertakings and intermediaries dealing with consumers, in an objective, timely and fair manner.

(iii) RSAs should require a compliance culture among providers of *takāful* products and services.

(iv) *Takāful* operators and intermediaries offering consumer products should be subject to requirements for fair treatment of consumers, including:

a. regard to information needs of consumers;
b. avoidance or management of conflicts of interest - in particular, through incentive structures;
c. fitness and propriety of those advising consumers;
d. training and competence requirements for those advising consumers;
e. establishment and maintenance of processes for assessment of suitability;
and
f. establishment and maintenance of processes for complaint handling.

(v) Consumer business should be presumed to be given on an advised basis with an implied duty of care, with limited justifications for consumer opt-out.

(vi) All contract and promotional material relating to *takāful* products should be required to be fair, clear and not misleading.

(vii) The institutional structure should provide for alternative dispute resolution mechanisms providing credible alternatives to formal legal action, for consumers to obtain redress.

Use of Intermediaries

(i) *Takāful* operators should be required to perform due diligence on intermediaries that they permit to distribute their products, and deal only with intermediaries that they have assessed as competent to distribute the product concerned, and with good business practices.

(ii) The legal and regulatory structure should provide for approval of *takāful* intermediaries before they are permitted to practise, after assessing their fitness and propriety including knowledge of *takāful*.

(iii) The legal and regulatory structure should provide for clear definition of the status of money held by an intermediary for onward transmission to the *takāful* operator or the policyholder, including:

a. requirement for segregation of such moneys from the intermediary's own money; and

b. deemed agency of the intermediary such that the insurer bears credit risk.

(iv) The legal and regulatory structure should provide for registration and supervision of online platforms such as price comparison websites, and the making of rules to limit practices of such operations that adversely affect consumer interests.

Disclosure and Sales Practices

(i) *Takāful* operators and intermediaries should be required to establish and maintain policies and procedures for:

a. The development of products, including determination of target customer base and Sharī'ah review;

b. The review and approval of all contract and associated documentation including promotional material, including Sharī'ah review and approval, prior to its use;

c. the assessment of suitability of products for consumers, where a product is to be offered to consumers;

d. the sale of products to consumers where the consumer declines to allow an assessment of suitability or where the assessment is that the product is not suitable.

(ii) Before a customer who is a consumer purchases a *takāful* product the *takāful* operator salesperson/intermediary selling the product should provide in writing a Key Facts Statement or similarly named document in

prescribed form, written in plain language, describing the key terms and conditions, and including a description of the Sharī'ah approval of the business model and contract.

(iii) Before entering into the contract, the policyholder should be provided with:

a. the terms of the contract;
b. details of all charges, fees and commissions in respect of the contract, including *wakālah* fees;
c. description of automatic renewal, contribution escalation, lapse and surrender provisions of the contract;
d. evidence of Sharī'ah review of the business model, contract and associated documentation (including promotional material relating to the contract); and
e. information on the financial condition of the funds (PRF, PIF or both) into which the contract will be written.

(iv) Except where a customer who is a consumer explicitly declines the performance of a suitability assessment or where exempted by regulation, the *takāful* operator salesperson/intermediary should;

a. gather and record sufficient information from the customer to enable an assessment as to whether the product or service is appropriate to that customer;
b. perform and document such assessment;
c. inform the customer and obtain the consumer's acknowledgement of the analysis; and
d. warn the customer if the assessment is that the product is not suitable for the customer.

(v) Sales discussions between *takāful* operator salespersons or intermediaries and consumers should be recorded in written minutes, audio recordings or in the case of internet requests, electronic form.

(vi) *Takāful* contracts with customers who are consumers should be subject to a cooling-off period whereby the customer may cancel the contract without undue penalty.

(vii) Where a consumer is obliged to purchase any *takāful* product as a pre-condition for receiving another product, whether financial or non-financial (e.g. where a mortgage provider requires the purchase also of a credit *takāful* product), the customer should be free to choose the *takāful* provider.

(viii) Where a consumer is offered an add-on *takāful* product, whether or not compulsorily, the consumer should be informed of the product features, in

the same way as for a *takāful* product acquired separately, and informed of the consumer's right to shop around.

(ix) Staff of *takāful* operators and intermediaries who deal directly with consumers should receive adequate training and support, suitable for the type of the products or services being sold.

(x) Illustrations of prospective contract performance where the contract terms include entitlement to a share of investment performance or a share of underwriting surplus, should:

a. be based on assumptions appropriate to the contract in question (where not prescribed);
b. in the case of share of underwriting surplus, disclose the financial condition of the fund and the extent to which surplus must be devoted to *qarḍ* repayment before distribution can be made; and
c. in the case of share of surplus, disclose the basis upon which distribution is made.

Post-sale servicing and information

(i) *Takāful* operators should prepare periodic statements for each customer on contracts where contract terms include entitlement to a share of investment performance or a share of surplus, identifying amounts credited and the value of the investment, as appropriate.

(ii) Customers should be individually notified of changes in commission, fees, and charges whenever a change is made.

(iii) *Takāful* operators and intermediaries should maintain up-to-date customer records.

Privacy and Data Protection

(i) *Takāful* operators and intermediaries should comply with all relevant legislation, regulation or supervisory guidance relating to privacy and data protection. At a minimum *takāful* operators and intermediaries should:

a. maintain policies and procedures approved by senior management for the collection and processing of personal information;
b. inform customers of their policies for the use and sharing of personal information;
c. notify customers of their rights to inspect personal information and to correct erroneous or changed information; and

d. protect the confidentiality of personal information, making disclosure to other parties only where permitted.

Dispute Resolution Mechanisms

(i) *Takāful* operators and intermediaries should:

a. have clear procedures for handling consumer complaints, covering acknowledgement, classification, investigation process, resolution and internal reporting;

b. maintain up-to-date records of all complaints received; and

c. analyse complaints received in order to identify root causes and systemic deficiencies requiring attention.

(ii) Information on consumer complaints should be periodically compiled and periodically submitted to the RSA, including the level and nature of complaints received, the timeliness of complaint resolution and the nature of any remediation action planned or undertaken.

(iii) Consumers should have access to an affordable and efficient independent mechanism for recourse, such as an ombudsman or equivalent institution with effective enforcement capacity against *takāful* operators and intermediaries, where the consumer is dissatisfied with the outcome of the complaints process.

Financial Education

(i) A broadly based program of financial education and information should be developed to increase the financial capability of consumers, covering financial services generally including Islamic financial services.

(ii) The financial capability of consumers should be measured periodically to assess the effectiveness of financial education programmes.

Competition

(i) Competition policy in financial services should consider the impact of competition issues on consumer welfare, and especially limits on choice.

(ii) Platforms providing comparison services should be required to be transparent as to their coverage, subject to conflict of interest requirements and prohibited from entering into 'most favoured nation' or similar agreements with suppliers.

(iii) Competition authorities should conduct and publish periodic assessments of competition in retail financial institutions and make recommendations on how competition in retail financial institutions can be enhanced.

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