LEMBAGA PIAWAIAN PERAKAUNAN MALAYSIA
MALAYSIAN ACCOUNTING STANDARDS BOARD

Discussion Paper *i*-1

Takaful

Comments to be received by 16 March 2012

This Discussion Paper (DP) is issued by the Malaysian Accounting Standards Board for comment only. The recommendations in this Discussion Paper may be modified in light of comments received.

Comments should be submitted either in writing or via MASB's online response page on its website, so as to be received by 16 March 2012. All replies will be placed on public record unless confidentiality is requested by the commentator.

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Note on numbering of Malaysian Financial Reporting Standards

On 19 November 2011, the MASB announced the issuance of Malaysian Financial Reporting Standards (MFRSs). The numbering of a MFRS corresponds to the numbering of the equivalent International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), and a MFRS prefixed by "1" corresponds to its equivalent International Accounting Standards (IAS). For example:

MFRS without prefix	MFRS 1 is equivalent to IFRS 1 *First-time adoption of International Financial Reporting Standards.*
MFRS prefixed by "1"	MFRS 101 is equivalent to IAS 1 *Presentation of Financial Statements.*

Similarly, the numbering of a MASB Issues Committee (IC) Interpretation also corresponds to the numbering of the equivalent IFRS Interpretations Committee (IFRIC) Interpretation, and an IC Interpretation prefixed by "1" corresponds to its equivalent Standing Interpretations Committee (SIC) Interpretation. For example:

IC Interpretation without prefix	IC Interpretation 1 is equivalent to IFRIC 1 *Changes in Decommissioning, Restoration & Similar Liabilities.*
IC Interpretation prefixed by "1"	IC Interpretation 107 is equivalent to SIC 7 *Introduction of the Euro*.

Throughout this Discussion Paper, references are made to both MFRS and to the equivalent IFRS.

MASB DP *i*-1 Takaful

The Malaysian Accounting Standards Board (MASB) has approved the release of this Discussion Paper, MASB DP *i*-1, for distribution to professional accounting bodies, regulators, users and other interested individuals and organisations for comment.

Background

Currently, little has been written about accounting for *takaful* under International Financial Reporting Standards (IFRS). In view of the MASB's policy of convergence with the IFRS, it is timely to introduce the issues that might ensue from applying IFRS to *takaful* transactions in Malaysia.

In many material aspects, *takaful* can be likened to conventional insurance, but there are distinct features which warrant further discussion from a financial reporting perspective. First and foremost, it needs to be established whether *takaful* meets the definition of an insurance contract in IFRS 4 *Insurance Contracts* (adopted by MASB as MFRS 4 *Insurance Contracts*). Additionally, due to the nature of the relationship between a *takaful* operator and the participants' funds it manages, there is a need to consider whether a *takaful* operator should prepare consolidated financial statements. Also, regulators may require a *takaful* operator to extend *qard*, an interest-free loan, to a participants' fund that is in deficit – giving rise to issues regarding the measurement of *qard*, its presentation the financial statements, and how it may affect the relationship between a *takaful* operator and the participants' funds.

MASB DP *i*-1 does not constitute prescriptions for these issues. Rather, it is issued to seek confirmation of the Board's understanding of the issues, as well as to solicit views on the alternative solutions and the tentative conclusions.

The Working Group

The Working Group on this Discussion Paper is chaired by the Chairman of the MASB, and comprises representatives from the accountancy profession, commerce and user groups. Members and Observers of the Group are:

Members

En. Mohammad Faiz Mohd Azmi, Chairman
En. Ahmad Nasri Abdul Wahab (KPMG)
En. Abdul Rauf Rashid (EY)
En. Mohamad Yasin Abdullah (Maybank Investment Bank)
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Observers

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En. Azli Munani (Malaysian Takaful Association)
En. Mohamed Rithuan Dato' Mohamed Shamsudin (AIBIM)
Ms. Zulfa Abd Rahman (Malaysian Institute of Accountants)

Additionally, participants of the Takaful Sub-Committee of Working Group 52 (Insurance) also provided input to the Discussion Paper.

Invitation to comment

The Malaysian Accounting Standards Board invites comment on any aspect of this discussion paper, particularly on the questions set out below. Comments are most helpful if they:

(a) address the questions as stated;

(b) indicate the specific paragraph or paragraphs to which the comments relate;

(c) contain a clear rationale; and

(d) describe any alternatives the Board should consider.

Respondents need not comment on all of the questions. Respondents are also encouraged to comment on any additional issues within the scope of the Discussion Paper.

Question 1 – Definition and scope

(a) Do you think *takaful* meets the definition of an 'insurance contract' in MFRS 4 *Insurance Contracts*? Why or why not?

(b) Do you think the requirements of MFRS 4 are applicable to a participants' fund? Why or why not?

(c) Do you think the requirements of MFRS 4 are applicable to a *takaful* operator? Why or why not?

Question 2 – Measurement of *qard*

(a) What do you think should be the initial and subsequent measurement bases for *qard* extended by a *takaful* operator to a participants' fund?

(i) cost; (ii) amortised cost; (iii) fair value; (iv) as an item of expense; or (v) some other basis.

(b) If *qard* is measured at fair value, what do you think should be the 'prevailing market rate' in the inactive market for *qard*?

(i) the rate usually imposed on *qard*, which is nil;

(ii) the rate that would be applied to a commercial loan with the same quantum and terms; or

(iii) some other rate.

Question 3 – Presentation of financial statements

How do you think the financial statements of a *takaful* operator and participants' funds should be presented?

(a) as separate financial statements;

(b) as consolidated financial statements, with elimination of intragroup balances, transactions, income and expenses;

(c) as combined financial statements, without elimination of certain intragroup balances, transactions, income and expenses; or

(d) some other presentation.

Question 4 – Re*takaful* contracts

(a) Would the financial reporting requirements for an insurance contract be appropriate for a re*takaful* contract? Why or why not?

(b) Do you know of any aspect of re*takaful* that may require further consideration for financial reporting purposes? If you do, please explain what these may be.

Question 5 – Participation features

When would it be most appropriate to recognise a liability arising from a participation feature of a *takaful* contract?

(a) at the inception of the *takaful* contract; or

(b) when an amount arising from that participation feature is to be paid.

Question 6 – Recognition and presentation of revenue

(a) Do you agree that in a *takaful* operator's separate financial statements, only service fees and/or the *takaful* operator's share of investment returns should be recognised as income?

(b) Do you agree that in a *takaful* operator's combined or consolidated financial statements, participants' contributions in their entirety can be recognised as income?

Question 7 – Matters for improvement

Is there any area of the discussion paper which needs to be improved? If so, please specify the area and put forward your suggestion(s).

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This Discussion Paper is issued for public comment only and is not an MASB approved accounting standard. Nothing in this Discussion Paper overrides any specific MASB approved accounting standards. However, in extremely rare circumstances where there is a Shariah prohibition to a requirement in an MASB approved accounting standard, that requirement need not be complied with.

Introduction

Reason for issuing the Discussion Paper

IN1 The Malaysian *takaful* industry has been growing since its inception in 1984. In view of *takaful*'s increasing economic importance, and developments at IASB with regards to accounting for insurance contracts, the MASB thought it timely to study accounting issues relating to *takaful*.

IN2 As there are many similarities between insurance and *takaful*, the MASB has had several meetings with the Malaysian Takaful Association (MTA) and other *takaful* stakeholders to discuss the applicability of IFRS 4 *Insurance Contracts* to *takaful*. During discussions on Phase I of IFRS 4, stakeholders suggested excluding *takaful* from the scope of the proposed MASB standard on insurance contracts until a thorough study was conducted to assess its applicability to *takaful*. However, the Board disagreed to an explicit exemption for *takaful* entities. Phase I had featured limited improvements and focused mainly on disclosures, thus the Board thought that Phase I's impact to *takaful* entities, if IFRS 4 was applicable, would be minimal. In November 2008, MASB adopted IFRS 4 without an exemption for *takaful* entities.

IN3 In July 2010, the IASB issued an exposure draft (ED) on insurance contracts, embodying Phase II of its insurance project which focused on recognition and measurement. IASB's insurance ED was discussed by MASB Working Group 52 (Insurance) and its Takaful Sub-committee. Once finalised as an IFRS, and adopted as an approved accounting standard by MASB, *takaful* entities are unlikely to be exempted from the recognition and measurement requirements of the revised MFRS on insurance contracts, or from any other MFRS. This is in line with MASB's policy that *Shariah* compliant transactions and events shall be accounted for in accordance with MASB approved accounting standards in the absence of a *Shariah* prohibition. Thus, it is imperative that MASB provide an avenue for stakeholders to provide feedback on *takaful* accounting issues in view of the 1 January 2012 convergence date.

Main features of the Discussion Paper

IN4 In view of Malaysia's convergence with IFRS, and the MASB's policy that its approved accounting standards shall apply to *Shariah* compliant transactions, this Discussion Paper primarily discusses the implications of MFRS 4 and IASB's July 2010 ED on insurance contracts, as well as other IFRS that may affect accounting for *takaful*. Nevertheless, due consideration is also given to standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Bank Negara Malaysia (BNM) guidelines, Islamic Financial Services Board (IFSB) standards, and other literature on *takaful* accounting.

IN5 This Discussion Paper outlines key accounting issues brought to the attention of the MASB during its meetings with stakeholders in the *takaful* industry, as well as the alternative solutions that were suggested. This Discussion Paper is issued to seek confirmation of the Board's understanding of the issues, as well as to solicit views on the alternative solutions.

Discussion Paper *i*-1
Takaful

What is *takaful*?

1 Modern *takaful* arrangements are designed to offer participants protection that is comparable with conventional insurance whilst adhering to *Shariah* principles. From an Islamic perspective, a conventional insurance contract is seen as a sale of protection by the insurer in return for a premium as consideration from the policyholder. Such a sale contract is deemed to be *haram* because it contains the prohibited elements of *gharar* (uncertainty), *riba* (‘excess’ or usury), and *maisir* (gambling).

2 *Takaful* is established on the concepts of *tabarru’* (donation) and *ta’awun* (mutual cooperation). Instead of purchasing insurance from an insurer, *takaful* participants pay contributions to a fund to mutually indemnify each other. In the event that a member suffers a loss, the other participants agree to forgo part or all of their contributions to the aggrieved member. A *takaful* operator would manage the fund and may receive a fee and/or a share of the fund’s profits and surpluses[1], depending on how the arrangement between the operator and the participants is structured.

3 Theoretically, should there be an excess of claims over available funds, the participants would be liable to make good the shortfall. However, in many jurisdictions, regulators would require the *takaful* operator to provide financial assistance usually by way of *qard*, an interest-free loan, to the participants’ fund, which would be recovered from future surpluses. Thus, in practice, participants would be unlikely to be called for additional contributions where a fund is in deficit.

4 *Takaful* products often have an investment element in addition to risk sharing. In Malaysia, contributions paid by participants will be placed in two funds - an investment fund called a “participants’ account”, and a *tabarru’* fund called a “participants’ special

[1] Dr Engku Rabiah Adawiyah Engku Ali, Hassan Scott P. Odiermo, Azman Ismail, *Essential Guide to Takaful (Islamic Insurance),* Centre for Research and Training (CERT), 2008, pp. 31 and 32.

account" which serves as the risk fund.

5 In recent years, re*takaful* has been developed as a *Shariah* compliant alternative to reinsurance. A *takaful* operator acts as an agent on behalf of participants to use re*takaful* as a mechanism to share risk. Through re*takaful*, fluctuating risk exposures from various funds managed by various *takaful* operators are shared to create a larger group of participants. With this mechanism, risk exposures are stabilized so the overall costs to manage risks are more predictable.[2] If a *takaful* operator uses risk sharing across different schemes, the risks are grouped in order to form a larger participant base for those particular risks. This more predictable estimate of the overall cost of the risks is then re-distributed in the form of contribution for each participant in each scheme.[3]

Accounting Considerations

6 There are several aspects of *takaful* which have led to questions regarding its accounting treatment under MFRSs. Many of these arise due to certain features of the modern *takaful* arrangement which render them economically similar to conventional insurance. In particular, the accounting issues that have been identified are as follows:

(a) The scope of MFRS 4 *Insurance Contracts*;

(b) Classification and measurement of *qard*;

(c) Consolidation and presentation of financial statements;

(d) Re*takaful*;

(e) Participating contracts;

(f) Revenue recognition; and

(g) Disclosures.

[2] Muhaimin Iqbal, *General Takaful Practice*, Gema Insani, Jakarta, 2005, p. 30

[3] *Ibid.*

The scope of MFRS 4 *Insurance Contracts*

Risk transfer and risk-sharing

7 MFRS 4 neither explicitly requires nor prohibits its application to *takaful*. Paragraph 2 of MFRS 4 states that an entity shall apply MFRS 4 to insurance contracts (including reinsurance contracts) that it issues and reinsurance contracts that it holds, and further defines an insurance contract as:

> *"A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."*
>
> MFRS 4 *Insurance Contracts*, Appendix A.

8 The definition provided by MFRS 4 has given rise to the question as to whether or not a *takaful* contract is considered an 'insurance contract' under MFRS 4. Other Islamic-focused standard setters, such as AAOIFI and the IFSB provide markedly different definitions for Islamic insurance, i.e. *takaful*, as reproduced below:

> *"Islamic insurance is a process of agreement among a group of persons to handle the injuries resulting from specific risks to which all of them are vulnerable. A process… involves payment of contributions as donations, and… establishment of an insurance fund that enjoys the status of a legal entity…The resources of this fund are used to indemnify any participant who encounters injury."*
>
> AAOIFI Shari'a Standard No. 26 *Islamic Insurance*, paragraph 2.

> *"[In] Takaful… a group of participants agree among themselves to support one another jointly for the losses arising from specified risks… the participants contribute a sum of money as tabarru' commitment into a common fund, which will be used for mutual assistance of the members against specified loss or damage."*
>
> IFSB 8, *Guiding Principles on Governance for Takaful (Islamic Insurance) Undertakings*, page 27.

9 There are two key elements in the definition given by MFRS 4 to consider in discussing its potential application to *takaful*: (i) the insurer's acceptance of significant insurance risk, and (ii) an agreement to compensate the policyholder.

10 In conventional insurance, the insurer is the party who accepts the risk from policyholders that was transferred to them at the inception of the insurance contract (risk transfer). In *takaful*, the participant pays a contribution into a pool of participants' funds, which would be utilised to support claims from individual participants. It is the participants as a collective, and not the *takaful* operator, that directly accepts the insurance risk from the individual participants. Thus, it can be said that *takaful* is characterised by risk-sharing, not risk transfer.

11 Some believe that risk-sharing is completely different from risk transfer and thus a *takaful* contract would not fall within the scope of MFRS 4. Others have expressed no objection to including the participants' fund within the scope of MFRS 4, as it is deemed to have accepted significant insurance risks from the individual participants.

Arguments that a takaful operator is not an insurer

12 There are, however, differing views as to whether or not the *takaful* operator would also fall within the scope of MFRS 4. Those who disagree to applying MFRS 4 to a *takaful* operator state that a *takaful* operator only acts as a manager of the fund; it is not an insurer because it has not agreed to compensate a participant if a specified uncertain future event adversely affects the participant. Any payment made by the *takaful* operator to a claimant is made on behalf of the participants' fund and is recoverable from the fund.

13 Paragraph B19 (b) gives specific examples of contracts that would not be considered insurance contracts. Namely, if a contract passes significant insurance risk back to the policyholder, the contract is not within the scope of MFRS 4.

> *"The following are examples of items that are not insurance contracts:*

> *… contracts that have the legal form of insurance, but pass all significant insurance risk back to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder as a direct result of insured losses…"*
>
> MFRS 4, *Insurance Contracts*, paragraph B19 (b).

14 On initial reading, paragraph B19 (b) may appear to exclude a *takaful* operator from the scope of MFRS 4, as the overarching premise of *takaful* is to spread the insurance risk among the participants – which could be viewed as the operator passing 'all the significant insurance risk back to the policyholder'.

15 However, in critically examining the description in paragraph B19 (b), the terms of *takaful* are notably different than what is being described. Firstly, *takaful* is usually a cancellable contract, as the participant can terminate the contract at any time. Thus, if there is a deficit in the pool that is temporarily funded by the *takaful* operator, it may be difficult to compel a participant to pay higher contributions as a result of these 'insured losses'. The participants can decide to cancel their *takaful* contract instead of paying increased contributions. This leads to the second difference between *takaful* and the contract described in paragraph B19 (b) – the *takaful* operator usually does not have an 'enforceable mechanism' to extract additional payments out of the participants as a direct result of insured losses. If the participants' fund experiences a deficit, the operator usually cannot immediately increase contributions on existing policies to cover for those losses. Instead, the operator can only impose higher contributions on either renewal of expired policies or on new policies.

Comparison with a mutual insurer

16 Those who believe that a *takaful* operator should be included within the scope of MFRS 4 cite paragraph B17 as a basis. Paragraph B17 discusses whether a structure with a pooling of insurance risk can be considered to have accepted the insurance risk. It provides the example of a pooling of risks by a mutual insurer:

> *"An insurer can accept significant insurance risk from the policyholder only if the insurer is an entity separate from the policyholder. In the case of a mutual insurer, the mutual accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively in their capacity as owners, the mutual still has accepted the risk that is the essence of an insurance contract"*
>
> MFRS 4, *Insurance Contracts,* paragraph B17.

17 A reading of paragraph B17 reveals that the definition of insurance risk would include a pool of risks as well. From the description provided, it may appear that the pooling of risks propagated by mutual insurers is similar to the pooling of risks in *takaful* operations. As the mutual is deemed to have accepted insurance risk, it is analogised that the *takaful* operator has as well.

18 However, *takaful* is not exactly the same as mutual insurance. A mutual insurer is owned entirely by its policyholders, not by shareholders. In terms of ownership, a mutual insurer is more akin to a participants' fund than to a *takaful* operator. A mutual insurer can, however, appoint an independent manager to manage its funds – in much the same way that a *takaful* operator manages a participants' fund. Thus, it is counter-argued that a *takaful* operator is analogous to an independent manager of a mutual insurer, and not to the mutual insurer itself.

Acceptance of significant insurance risk

19 It is, however, untenable to believe that the *takaful* operator's role is limited to fund management, and that it is not exposed to any degree insurance risk. Extending the comparison with mutual insurance, an independent manager would usually have no fiduciary duty to assist a failing mutual insurer; a *takaful* operator does. In many jurisdictions, regulations (or at the very least, expectations) would compel a *takaful* operator to lend financial assistance to an ailing participants' fund. Furthermore, regulation may require repayment of *qard* to the operator to be subordinate to other claims. Some may argue that *qard*, as a loan, would pose a financial risk, not an insurance risk, to the *takaful* operator. However, since repayment of *qard* is strongly related to, and

dependent upon, the underwriting results of the participants' fund, it could constitute exposure to significant insurance risk. When a *takaful* operator knowingly undertakes to enter into a business where it would be exposed to that risk, it could further constitute "acceptance of significant insurance risk".

20 There are other indicators that the economic risk exposures of a *takaful* operator are similar to the risk exposures of a conventional insurer. In addition to the operator's exposure to risks through *qard*, a *takaful* operator also usually bears other costs directly related to insurance. This exposure could indicate insurance risk, as the costs may exceed the service fees, resulting in the operator having to 'pay out' on behalf of the participants. Moreover, a *takaful* operator undertakes many of the same activities as an insurer; in addition to underwriting and investment management, an operator would also undertake claims processing, loss adjusting, marketing, and appointment of agents. It should be noted, however, that these activities could also be undertaken by third parties unrelated to the *takaful* arrangement and thus should not be taken, in and of themselves, as evidence of acceptance of significant insurance risk, but should be considered in light of other accompanying factors and circumstances.

Takaful investment contracts

21 As stated earlier, *takaful* contracts have investment elements embedded within them. The investment element creates a financial risk, not an insurance risk. Financial risk is not within the scope of MFRS 4. Instead, these investment products would fall within the scope of IAS 32, *Financial Instruments: Presentation* (adopted by MASB as MFRS 132) and IAS 39, *Financial Instruments: Recognition and Measurement* (adopted by MASB as MFRS 139). However, if the investment element constitutes a financial instrument with a discretionary participation feature, then it may fall within the scope of MFRS 4.

Tentative conclusions on the scope of MFRS 4

22 A participants' fund which has accepted the transfer of risk from an individual participant to a pool of participants shall apply MFRS 4 to that contract which transfers the risk from the individual participant to the pool of participants.

23 A *takaful* operator that is deemed to have accepted significant insurance risk shall apply MFRS 4 to the transaction deemed to have transferred the risk. The acceptance of significant insurance risk need not be a direct, overt acceptance but may result from the presence of factors and circumstances indicating significant insurance risk has been transferred. Indicators that a *takaful* operator has accepted significant insurance risk may include a requirement to fund excess losses in a participants' fund, to bear costs directly related to *takaful*, and to undertake activities related to *takaful*. In making the assessment, an indicator should not be taken, in and of itself, as evidence of acceptance of significant insurance risk, but should be considered in light of other accompanying factors and circumstances.

24 A *takaful* contract which does not represent a significant insurance risk is not deemed an insurance contract within the scope of MFRS 4, but may instead fall within the scope of MFRS 132 and MFRS 139.

Classification and measurement of *qard*

25 If a *takaful* operator was acting purely as a manager then, theoretically, deficiencies in a participants' fund would be rectified by further contributions from participants. However, in reality, pursuing such a course of action may be detrimental to existing participants and deter future participants from entering the fund.

26 For consumer protection, regulators in many jurisdictions, including Malaysia, require a *takaful* operator to provide financial assistance (usually through *qard*) to a deficient fund. This would prevent the moral hazard of a *takaful* operator continuing to enjoy fees irrespective of the health of its participants' funds, whilst an insurance company in a similar situation would bear its policyholders' deficiencies. It is also in the interest of consumer protection that regulatory capital requirements for *takaful* operators are often similar to those for conventional insurers.

27 There are three different views on how *qard* should be classified:

(a) *As an expense of the takaful operator.*

Some have proposed that *qard* be expensed as an appropriation of profits.[4] While a *takaful* operator would certainly like to recover *qard* in future, having to top-up a participants' fund is part and parcel of the operator's duties and it is thus a cost of undertaking a *takaful* business. This is particularly in line with the classical *Shariah* view on *qard hasan*, a benevolent interest-free loan, which is while repayment is welcome, it is not expected.[5]

(b) *As the takaful operator's 'equity' in the participants' fund.*

Others, however, have likened *qard* to an equity interest in a subsidiary as the *takaful* operator has control over the fund. As equity, *qard* could be measured at cost under paragraph 38 of IAS 27.[6]

(c) *As a financial instrument.*

Finally, a third group believes *qard* is a financial instrument, because *takaful* operators expect *qard* to be repaid from the fund's eventual surplus (irrespective of the tenure of the *qard*). There is some *Shariah* basis for the financial instrument approach, because a strict interpretation would dictate that *takaful* participants should ultimately bear the risks of the fund, and therefore, have a real obligation to repay the *qard*. [7] If *qard* is classified as a financial instrument, there is a second question to be answered – how should it be measured?

Qard as an expense

28 Expenses, as defined in paragraph 78 of the MASB's *Framework for the Presentation and presentation of Financial Statements* (*Framework*), "arise in the course of the ordinary activities of the entity… they usually take the form of an outflow or depletion of

[4] Omer Morshed, *"Takaful Accounting"* , Pakistan, Sidat Hyder Morshed Associates (Pvt) Ltd, 2003, p. 8

[5] Asian-Oceanian Standard-setters Group (AOSSG) Research Paper, *"Financial Reporting Issues relating to Islamic Finance"*, Japan, 2010, p. 29

[6] *Ibid.*

[7] *Ibid.*

assets.” In Malaysia, *qard* may not be considered an ‘expense’ because it is not a pure ‘depletion of assets’. Instead, it represents a claim that the *takaful* operator has on future returns of the participants’ fund, as its shareholders plan on getting repaid (unlike an expense where the amount paid is not expected to be returned). However, in some jurisdictions, the financial assistance may be in the form of *qard hasan*, a benevolent interest-free loan, which may be treated as an expense where there is no expectation for the *qard hasan* to be repaid. Instead, the *takaful* operator may expect to derive other income by keeping the participants’ fund solvent. In such circumstances, *qard hasan* may fit into the definition of an expense as it would be a ‘depletion of assets’ with no expected return of principal.

Qard as ‘equity’

29 Some stakeholders have suggested that since *qard* is a capital injection by a *takaful* operator into a participants’ fund, it may be likened to a parent entity’s investment in a subsidiary, i.e. an item of ‘equity’. According to paragraph 49 of the *Framework*, equity is defined as ‘the residual interest in the assets of the entity after deducting all its liabilities’. This definition may be apt because regulators often require repayment of *qard* to be subordinated to all other liabilities, rendering *qard* a residual interest in the assets of the participants’ fund.

30 Under paragraphs 10-11 of MFRS 108 *Accounting Policies, Changes in Accounting Estimates and Errors*, in the absence of an IFRS that specifically applies to a transaction, management is required to refer to and consider the applicability of the requirements in IFRSs dealing with similar and related issues. Currently, some stakeholders in Malaysia believe that *qard* is similar enough to an investment in a subsidiary that it would be appropriate for *qard* to be considered as a *takaful* operator’s ‘equity’ in the participants’ fund, and elect to measurement at cost as allowed by MFRS 127. Indeed, BNM guidelines specifically require measurement of *qard* at cost, less impairment. Paragraph 38 of MFRS 127 reads:

> *“When an entity prepares separate financial statements, it shall account for investments in subsidiaries, jointly controlled entities and associates either:*
>
> *(a) at cost, or*

> *(b) in accordance with MFRS 139…"*
>
> MFRS 127, *Consolidated and Separate Financial Statements*, paragraph 38.

31 However, there is a flaw to this analogy. A parent entity provides capital infusions with the expectation that its subsidiary will be profitable in the future, and that the subsidiary's profits will ultimately return to the parent. A *takaful* operator, in contrast, is not allowed to profit from *qard*, but to merely recoup the principal. Thus, the business purpose for parent entity investing into a subsidiary and the purpose of the *takaful* operator providing *qard* fundamentally differs.

Qard as a financial instrument

32 Some believe *qard* represents a financial instrument. Paragraph 9 of MFRS 139 states that financial assets would be classified as one of four categories: (1) financial assets with fair value changes through profit and loss, (2) held-to-maturity investments, (3) loans and receivables, or (4) available-for-sale financial assets with fair value changes through other comprehensive income. These categories would determine whether a financial asset is measured at amortised cost or at fair value. On initial impression, 'loans and receivables' may appear to best describe *qard*. However, the definition of a loan and receivable in MFRS 139 require it to have fixed or determinable payments – which *qard* does not.

> *Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market other than:*
>
> *(a) those that the entity intends to sell immediately or in the near term;*
>
> *(b) those that the entity upon initial recognition designates as available for sale; or*
>
> (c) *those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available-for-sale…*
>
> MFRS 139 *Financial Instruments: Recognition and*

> *Measurement,* paragraph 9.

33 If *qard* fails to meet the definition of a loan and receivable, and hence fails to meet the criteria for measurement at amortised cost, the category that best fits would be 'available-for-sale financial assets'.

> *"Available-for-sale financial assets are those non-derivative financial assets that are designated as available-for-sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss."*
>
> MFRS 139 *Financial Instruments: Recognition and Measurement,* paragraph 9.

Measurement and impairment of qard

Measurement under MFRS 139

34 Paragraphs 43-46 of MFRS 139 prescribe that financial instruments classified as 'available-for-sale' should be measured at fair value, with fair value changes being recorded through other comprehensive income (OCI). MFRS 139 further provides guidance on determining the fair value of a non-interest bearing receivable, such as *qard,* using a discounted cash flow approach:

> "…the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest and other factors) with a similar credit rating."
>
> MFRS 139 *Financial Instruments: Recognition and Measurement,* Application Guidance, paragraph AG64.

35 Measuring *qard* at fair value poses some issues. For one, some believe that references to interest rates in discounting cash flows would conflict with *Shariah.* They have reservations about reporting Islamic financial transactions as financing because it may blur the distinction between *riba* transactions and *Shariah*-compliant ones, rendering them economically indistinguishable.

Even ‘progressive’ *Shariah* scholars who would generally have no qualms about references to interest rates for other commercial Islamic transactions may hesitate to allow applying an interest rate to discount cash flows from *qard*, regardless that no actual interest is charged.

36 There are two views about how to discount the future cash receipts of *qard* within the context of paragraph AG64 in arriving at the fair value:

(a) *The discount rate should reflect the prevailing rate for qard as its own class of asset, which would be nil.*

The majority of *Shariah* jurists rule that a return based on time value of money cannot be imposed on *qard* because it must not be commercial in nature. Accordingly, no *takaful* operator charges interest on *qard*. Therefore, the discount rate for the future cash receipts from *qard* should be nil because this is the prevailing market rate of interest for similar instruments (i.e. all *qard* as its own class of assets are similarly issued at zero per cent interest)

(b) *The discount rate should reflect the opportunity cost of extending the qard, which would be an internal rate, or a commercial rate, or the risk-free rate.*

Although the market rate for *qard* as a class of asset may be nil, providing *qard* over an indeterminate period carries opportunity cost for the *takaful* operator. Thus, it would be more useful to apply a discount rate that either reflects the entity’s cost of funds, or the rate of a commercial loan similar as to currency, term, type and other factors of the *qard*. Under this view, the use of these other ‘market’ rates would provide information on the opportunity costs forgone by the operator. This would be in line with paragraph AG74 of MFRS 139, which suggests using a valuation technique with reference to the fair value of other instruments across the market when market rates are not determinable.

Impairment

37 If *qard* is deemed an equity investment, impairment guidance is found in MFRS 128, *Investments in Associates*. MFRS 128 points users to the impairment guidance in MFRS 139, when determining whether an equity investment has been impaired.

> *"The investor applies the requirements of MFRS 139 to determine whether it is necessary to recognise any additional impairment loss with respect to the investor's net investment in the associate."*
>
> MFRS 128, *Investments in Associates,* paragraph 31.

38 If *qard* is deemed a financial instrument, or if *qard* is an equity instrument, paragraph 59 of MFRS 139 details general impairment guidance. It states that impairment should be recognised when losses are incurred:

> *"A financial asset…is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred… (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset... Losses expected as a result of future events, no matter how likely, are not recognized."*
>
> MFRS 139 *Financial Instruments: Recognition and Measurement,* paragraph 59.

39 Thus, under MFRS 139, impairment is recognised when incurred. Although impairment calculations are required for all financial instruments, some stakeholders do not believe *qard* should be impaired. This is because it is not a yielding asset and generally the entire *qard* amount will remain outstanding until the fund has enough surpluses to be fully repaid.

40 Others suggest that the impairment of *qard* should depend on whether the *qard* was given due to a technical loss or excess claims. *Qard* is not impaired when given merely due to a technical loss, for example to cover provisions for incurred but not reported (IBNR) claims, as there is no real cash outflow. However, if *qard* is extended to cover excess claims, then the

entity may need to consider impairment of *qard*.

41 With that said, the MFRSs and BNM are both clear that impairment considerations are required when reporting the amount of *qard*, regardless if it is considered equity or a financial instrument. Under BNM guidelines, *takaful* operators will have to determine the time period over which the *qard* is expected to be repaid. Beyond this, the *qard* shall be deemed irrecoverable.[8]

Prospective guidance on classification and measurement of qard

IFRS 9 *Financial Instruments*

Measurement

42 IAS 39 is being gradually replaced by IFRS 9, *Financial Instruments*, over three phases: classification and measurement, impairment, and hedge accounting. In 2009, the IASB released IFRS 9's requirements for classification and measurement of financial assets. In determining classification, IFRS 9 disregards management's intentions, and instead focuses on an entity's business model for managing financial assets. IFRS 9 limits the use of measurement at amortised cost:

> *"A financial asset shall be measured at amortised cost if both of the following conditions are met:*
>
> - *the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.*
> - *the contractual terms of the financial asset give rise on specified dated to cash flows that are solely payments of principal and interest on the principal amount outstanding."*
>
> IFRS 9, *Financial Instruments*, paragraph 4.1.2.

43 All other financial assets that are not accounted for at amortised cost would be required to be accounted for at fair value. With few

[8] Bank Negara Malaysia, *Guidelines on Financial Reporting for Takaful Operators* (BNM/RH/GL 004-6), section 7.2.

exceptions, any fair value changes would immediately be charged to profit and loss:

> *"A financial asset shall be measured at fair value unless it is measured at amortised cost in accordance with paragraph 4.1.2."*
>
> IFRS 9, *Financial Instruments*, paragraph 4.1.4.

> *"A gain or loss on a financial asset or financial liability that is measured at fair value shall be recognised in profit or loss unless:*
>
> (a) *it is part of a hedging relationship (see paragraphs 89-102 of IAS 39);*
>
> (b) *It is an investment in an equity instrument and the entity has elected to present gains and losses on that investment in other comprehensive income in accordance with paragraph 5.7.5; or*
>
> (c) *it is a financial liability designated as at fair value through profit or loss and the entity is required to present the effects of changes in the liability's credit risk in other comprehensive income in accordance with paragraph 5.7.7."*
>
> IFRS 9, *Financial Instruments*, paragraph 5.7.1.

44 *Qard* may not qualify for amortised cost for two reasons. Firstly, the business model of a *takaful* operator is to collect fees and share of investment returns; it does not plan to, and is not allowed to, profit from *qard*. Secondly, *qard* is repaid when the participants' fund has a surplus, and not on 'specified dates', violating the second criterion of 'giving rise on specified dates to cash flows'. Thirdly, the cash flows on *qard* represent payments of principal only, without interest.

45 In short, under IFRS 9 there would prospectively be less leeway for *qard* to be measured at anything other than at fair value. It may be noted that IFRS 9 retains the guidance in MFRS 139 on

determining the fair value of a non-interest bearing receivable, using a discounted cash flow approach[9].

> *"… For example, the fair value of a long-term loan or receivable that carry no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating..."*
>
> IFRS 9 *Financial Instruments: Recognition and Measurement,* paragraph B5.1.1.

Impairment

46 The second phase of IFRS 9 pertains to impairment. The revised guidance would change the impairment model from the existing incurred loss model to an expected loss model, potentially resulting in more losses being recognised earlier.

47 Under the expected loss model, investors would have to separate individual financial assets into a 'good book' and a 'bad book.' The bad book would typically comprise of all the financial assets that are nonperforming, or that have recognized losses. In the bad book, any expected losses would be immediately recognised when expected. Any assets that are not put in the bad book would automatically go to the good book. Expected losses on the financial assets in the good book would be recognized over the life of the assets per the methods discussed by the IASB.

48 This guidance appears to be a significant change from current guidance. For one, changing from an incurred loss model to an expected loss model would accelerate the recognition of impairment. Secondly, investors will have to determine how to quantify their loss expectations for reporting purposes.

49 It is foreseen that under the revised impairment guidance, *takaful* operators will recognise impairments on *qard* based on an

[9] This guidance can also be found in the Application Guidance to FRS 139, paragraph AG 64.

expected loss model – which would accelerate impairment recognition as compared to an incurred loss model.

IFRS 13 *Fair Value Measurement*

50 In addition to the changes communicated through IFRS 9, the IASB has also issued IFRS 13, *Fair Value Measurement*, which provides a single source of fair value measurement guidance. Under IFRS 13, fair value is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". This suggests the notion of determining an 'exit price' – a price that can be received to sell the financial instrument, which may be different than the price paid to obtain the financial instrument.

51 IFRS 13 requires market-focused prices to be considered in deriving fair value, but in an inactive market, an entity would have to consider unobservable inputs in fair valuing *qard*. This could mean incorporating the entity's internal data (such as costs of funds) into the fair valuation.

52 As this standard has yet to come into effect, it is unclear to what extent its implementation will affect current fair valuation practices. Nevertheless, in fair valuing *qard*, it is apparent that a *takaful* operator would need to consider both its entity-specific data as well as market-specific inputs.

Tentative conclusions on classification and measurement of qard

53 *Qard* appears to meet the definition of a financial instrument, and hence should be accounted for in accordance with MFRS 139. Under MFRS 139, *qard* would most likely be classified as available for sale, and thus would be measured at fair value, with fair value changes going through other comprehensive income.

54 The fair value of *qard* can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. As *qard* is extended due to regulatory requirements, and at interest-free terms due to *Shariah* requirements, it would be

inappropriate to use market lending interest rates to discount *qard*. Instead, the appropriate discount rate for *qard* would be the rate for all *qard* as a class of asset.

Consolidation and presentation of financial statements

55 The structure of a typical modern *takaful* undertaking comprises a normal shareholder-owned company, and embedded within it are funds considered to be the property of the participants, but which generally do not have separate legal personalities. Fundamentally this means that within the same legal entity there are pools of funds with different ownerships.

56 A corollary of fund segregation is that, at least in *Shariah* terms, not all the assets of the participants' funds can be utilised to meet the *takaful* operator's general obligations. For example, assets in the participants' fund cannot be used to pay the *takaful* operator's rent. How far the principle of fund segregation would be respected in the event of insolvency may vary from jurisdiction to jurisdiction, and has not been tested in practical cases. Nevertheless, for financial reporting purposes, many *takaful* undertakings would present separate financial statements for the funds it manages.

57 In Malaysia, BNM guidelines require separate financial statements to be prepared for the participants' funds even though the funds are not legal entities, and not registered under the National Trust Fund Act 1988. This presentation requirement would be in keeping with the *Shariah* view that the participants' funds are distinct from and 'independent' of the *takaful* operator.

58 However, BNM is cognizant of the fact that certain aspects of the modern *takaful* arrangement create a relationship between the operator and the participants' funds that may not be adequately conveyed through separate statements alone. As such, BNM guidelines also allude to aggregated financial statements to be prepared. The revised BNM guidelines[10] no longer specify the

[10] Bank Negara Malaysia, *Guidelines on Financial Reporting for Takaful Operators* (BNM/RH/GL 004-6), effective July 2011.

format that these aggregated statements must take; and while some stakeholders are amenable to the presentation of consolidated financial statements as required by MFRS 127, others have indicated a preference to retain the combined financial statement presentation required under the previous BNM guidelines[11].

59 The three alternative views on *takaful* financial statements are as follows:

(a) *The takaful operator and the takaful funds should present separate financial statements.*

A *takaful* operator is distinct from the participants' funds it manages, as the pools' assets are only available to meet the liabilities of that specific pool.

(b) *The takaful operator and the takaful funds should present combined financial statements*[12].

Separate presentations may not adequately reflect the economic relationship between a *takaful* operator and the funds it manages. Thus, there is some merit to an aggregated presentation. These combined statements would aggregate the *takaful* operator's and the participants' funds' income, expenses, assets and liabilities. As a note, combined statements are not synonymous with consolidated statements. One major difference is that some 'intragroup' transactions are not eliminated.

(c) *The takaful operator and the takaful funds should present consolidated financial statements.*

The participants' funds should be consolidated with the *takaful* operator as the operator controls these funds through management and decision making responsibilities. Although the participants share the risks, the operator sets the contributions that should be paid,

[11] Bank Negara Malaysia, *Garis Panduan, Takaful 6* (GPT-6).

[12] It should be noted that while the IASB's exposure draft entitled *Conceptual Framework for Financial Reporting: The Reporting Entity* discusses a combined financial statement presentation, there may be differences between the concept proposed by the exposure draft and as understood by Malaysian *takaful* stakeholders.

and determines how those funds are to be managed.

Separate financial statements

60 The current IFRS 4 allows entities to follow jurisdiction-specific accounting guidance for insurance contracts, unless it conflicts with other IFRS. In Malaysia, *takaful* accounting guidance is found mainly in Bank Negara Malaysia's *Guidelines on Financial Reporting for Takaful Operators* (BNM/RH/GL 004-6). The guidelines require separate financial statements to be prepared:

> *"Takaful operators shall report on the assets and liabilities of the takaful funds separately from the assets and liabilities of the takaful operators."*
>
> BNM *Guidelines on Financial Reporting for Takaful Operators* (BNM/RH/GL 004-6), paragraph 6.2.

61 Those who support the presentation of separate financial statements opine that recognition of the participants' funds as separate from the *takaful* operator is fundamental to the concept of *takaful* and that this separation has to be preserved in the presentation of financial statements. A parallel may be drawn with participating life insurance funds, where it is accepted that such a fund would not be consolidated or combined with the shareholders' fund of the insurer.

62 Moreover, although participants' funds are not considered trust funds under Malaysian law, and may not enjoy the status of separate legal entities under the National Trust Fund Act, the Takaful Act does provide that they are separate from the shareholders' funds.

Combined financial statements

63 The main text of the revised BNM guidelines does not overtly mention an aggregated presentation. However, its appendix alludes to elimination entries in the preparation of aggregated financial statements, suggesting they are still required.

64 The previous BNM guideline for *takaful* accounting, *Garis Panduan Takaful 6* (GPT 6) had included model accounts for an

operator and the funds it manages. Therein was an aggregated financial statement known as the ‘combined statement’ which presented the aggregated totals for the operator’s and funds’ income, expenses, assets and liabilities.

65 The requirement to present combined statements indicates that BNM was cognizant of the fact that there is an economic relationship between a *takaful* operator and the participants’ funds that was somewhat similar to an insurer and its policyholders’ funds; and that this relationship and similarity could not be conveyed through separate statements, thus requiring an aggregated presentation. However, GPT 6 had stopped short of requiring consolidated financial statements because it was thought an operator and its funds are not a single entity, and that it would be misleading to present them as a single consolidated entity.

66 It may be noted that in combined financial statements, some intragroup balances are not eliminated, namely *qard*. As *qard* is not eliminated, neither would be its corresponding credit entry. Thus, the combined statement could be showing a surplus that is bigger than it really is, or even mask a deficit. By eliminating the intragroup *qard* transaction under a consolidated approach, the group would show the actual surplus (or deficit), which would be useful information for financial statement users.

Consolidated financial statements

67 Under IFRS, the preparation of separate financial statements does not preclude the requirement to also prepare consolidated financial statements. Indeed, consolidation by nature would involve entities that are separate legal personalities, and whose assets and liabilities are legally segregated. Strictly following the requirements of MFRS 127, a *takaful* operator may need to prepare consolidated financial statements, as the *takaful* operator may have deemed control over the participants’ funds. Control exists when the parent has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities (MFRS 127, paragraphs 4 and 12). In assessing whether control exists, the *takaful* operator would consider its involvement in creating and managing the participants’ funds, and setting fees obtained from these funds. Additionally, it would need to consider its obligations to the funds, including any obligations to

cover excess losses (such as whether it provides *qard* should a shortfall occur).

68 However, many stakeholders have indicated that consolidated financial statements would not accurately represent the nature of the relationship between the *takaful* operator and the participants' funds. Opponents of consolidation argue that since not all assets of the funds are available to meet the operator's liabilities (e.g., the participants' funds are not available to pay the *takaful* operator's staff salaries) it would be misleading to consolidate the various asset pools. In addition, there is a perception that the financial statement presentation must reflect *Shariah* requirements for fund segregation, as within the separate *takaful* funds, the *takaful* operator is prohibited from cross-collateralising the assets of one fund with the liabilities of another. Furthermore, they believe that although control may be present, beneficial ownership is not, and that the position of the *takaful* operator is more analogous to that of a trustee. They believe it would be misleading to consolidate the accounts of a trustee with those of the trusts it controls. In this regards, stakeholders have indicated a preference to utilise paragraph 19 of IAS 1 to depart from consolidation:

> *"In the extremely rare circumstances in which management concludes that compliance with a requirement in an MFRS would be so misleading that it would conflict with the objective of financial statements set out in the Framework, the entity shall depart from that requirement …"*
>
> MFRS 101, *Presentation of Financial Statements*, paragraph 19.

69 In invoking MFRS 101, stakeholders have indicated they would prefer a combined presentation, with disclosure of the assets and liabilities of the participants' funds in the notes. However, as the IASB does not currently prescribe presentation guidance for combined financial statements, this could mean an entity would be departing from IFRS. In future, this could lead to a qualified audit opinion should Malaysian auditors' reports be required to include an opinion on compliance with IFRS.

70 It is important to note, however, that financial reporting assertions, in and of themselves, neither validate nor nullify *Shariah* compliance. In some IFRS-convergent jurisdictions, there are

examples of insurance companies overseeing policyholders' funds which are legally separate entities, and yet the 'parent' insurance company is required by jurisdictional accounting standards to consolidate these funds for financial reporting purposes[13]. These examples suggests that even if the funds are legally separate, and the assets of these funds are legally prohibited from being transferred to other funds, IFRS would require consolidated financial statements when the parent insurer controls the funds.

Prospective guidance on consolidation and presentation of financial statements

IFRS 10 *Consolidated Financial Statements*

71 The IASB has a two-part project to revise its consolidation guidance. The first part was completed through the issuance of IFRS 10, *Consolidated Financial Statements* in 2011. This guidance will replace MFRS 127 in future.

72 Similar to current guidance, IFRS 10 requires the *takaful* operator to determine whether it controls the funds. Control is now defined as including the ability to affect an entity's returns. IFRS 10 also suggests that control exists through power, the exposure or rights to variable returns, and the ability to affect those returns through power. These are guided below:

"An investor, regardless of the nature of its involvement with an

[13] See, for example, paragraph 4.1.1 of the Australian Accounting Standards Board (AASB) Standard 1038 *Life Insurance Contracts* which requires consolidation of the policyholders' and insurer's interests, despite legal separation of the funds:

"Life insurers may have both policyholders and shareholders with a financial interest in the entity. It is sometimes argued that the interests of policyholders and the interests of shareholders form the bases of separate entities that should prepare separate primary financial statements. However, the view adopted in this Standard is that the interests of policyholders and shareholders are intertwined and form the basis of a single entity. The boundaries of this entity are defined by control. The directors of the life insurer, in pursuing its objectives, govern the decision-making in relation to the financial and operating policies of the life insurer, which includes the assets of the entity, whether they are designated as relating to policyholders or to shareholders."

> *entity (the investee), shall determine whether it is a parent by assessing whether it controls the investee.*
>
> *An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.*
>
> *Thus, an investor controls an investee if and only if the investor has all of the following:*
>
> *(a) power over the investee…*
>
> *(b) exposure, or rights, to variable returns from its involvement*
>
> *(c) the ability to use its power over the investee to affect the amount of the investor's returns."*
>
> IFRS 10, *Consolidated Financial Statements*, paragraphs 5 to 7.

73 Paragraph 10-18 of IFRS 10 clarifies that there are multiple ways in which power can arise. Power can arise from existing rights, such as an entity's ability to direct the activities that significantly affect its returns. The ability to direct can result from having a majority of the voting rights, although a majority of the voting rights is not required. Finally other contractual rights that relate to the relevant activities could constitute power, such as the ability to choose management. The ability for other parties to block or prohibit the exercise of power will impact this assessment.

74 IFRS 10 includes an Application Guidance which provides a more extensive discussion than MFRS 127 on assessing control. Among other considerations, the Application Guidance discusses the effect of power, the exposure or rights to variable returns, and the link between power and returns in determining whether control exists. Paragraph B19 of IFRS 10 gives the instances where, in combination with other rights, would indicate power.

> *"…The following suggests that the investor has more than a passive interest in the investee and, in combination with other rights, may indicate power:*
>
> *(a) The investee's key management personnel who have the ability to direct the relevant activities are current or previous employees of the investor*

> *(b) The investee's operations are dependent on the investor, such as in the following situations: …*
>
> *(ii) The investor guarantees a significant portion of the investee's obligations*
>
> *(iii) The investee depends on the investor for critical services, technology, supplies or raw materials.*
>
> *(iv) The investor controls assets such as licenses or trademarks that are critical to the investee's operations.*
>
> *(v) The investee depends on the investor for key management personnel, such as when the investor's personnel have specialised knowledge of the investee's operations"*
>
> IFRS 10, *Consolidated Financial Statements*, paragraph B19.

75 Although IFRS 10 clearly states that meeting only one indicator of power would not necessarily mean the entity must consolidate, it appears there are multiple indicators of power that apply to *takaful* operators. For instance, in the context of paragraph B19(a), the *takaful* operator would typically provide personnel, such as chief executive officer, who would drive and direct the *takaful* fund operations. Paragraph B19(b)(ii) would also apply as the *takaful* operator guarantees the *takaful* fund's operations through the requirement to provide *qard* in times of deficit. The purpose of this 'financial assistance' is to maintain the sustainability of the fund. The *takaful* operators also provide a common platform for managing the operations such as the same accounting software for the use of both the operator and the fund. Both the operator and the fund work under the same brand and insurance/*takaful* license which are both critical for the operations of the business. Finally, the *takaful* fund depends on the operators' key personnel such as human resources, accounting, marketing, etc. in managing the operations of the *takaful* business. Thus, the *takaful* operator is responsible for day to day activities such the allocation of resources, supplies and other services. These instances show that the *takaful* fund meets the indicators discussed in B19, and is thus dependent on the *takaful* operator in all aspects of the *takaful* operations. As such, the *takaful* operator appears to have power over the *takaful* funds.

76 Additionally, an entity's exposure or rights to variable returns from another entity must also be considered in assessing control.

> *"When assessing whether an investor has control of an investee, the investor determines whether it is exposed, or has rights, to variable returns from its involvement with the investee."*
>
> IFRS 10, *Consolidated Financial Statements*, paragraph B55.

In a *takaful* arrangement, the *takaful* operator often has a right to a share in the investment returns of the participants' fund, and these returns are variable depending on the performance of the funds. Under IFRS 10, this right to a variable return must be taken in light of the entity's power to affect those returns which would include considering whether the decision maker was acting as an agent or principal. Given, however, the scope of the *takaful* operator's decision making authority, it may be difficult to argue that it is merely an agent.

77 Thus, although the proposed guidance is still a controls-based approach, which is consistent with the current guidance, the change in definition of what 'control' is, and the inclusion of distinct characteristics of power, and how power links to exposure or rights to variable returns would increase the likelihood that participants' funds would need to be consolidated by the *takaful* operator.

IASB Exposure Draft ED/2011/4 *Investment Entities*

78 In the second part of IASB's revision of its consolidation standard, the IASB plans to provide special consideration for 'investment entities'. The proposals in the exposure draft *Investment Entities* would exempt an investment entity from consolidating entities that it controls. The concept is that an investment entity, such as a mutual fund manager, should not consolidate the investment funds it manages even though it 'controls' these funds through making active management decisions, because these funds belong to third-party investors and not the investment entity.

79 *Takaful* operators could be viewed has being similar to an investment entity in that they primarily 'manage' the participants' funds – as the assets in the participants' funds belong to the

participants and not to the *takaful* operator. Thus, some argue that the proposed requirements for an investment entity could apply to a *takaful* operator hence exempting it from consolidating the participants' funds under IFRS. Although certain analogies can be drawn, a *takaful* operator may not meet the definition of an 'investment entity'. That is because an investment entity is very narrowly defined: among other criteria, paragraph 2(a) of the exposure draft proposes that "the entity's only substantive activities are investing in multiple investments for capital appreciation, investment income or both". As *takaful* operators have activities that are well beyond the scope of paragraph 2(a), they may not be considered investment entities, and may not qualify for this consolidation exception. Thus, they would have to perform a control-based assessment when determining whether the participants' funds should be consolidated by the operator.

80 In conclusion, under both the current consolidation standard and the proposed consolidation guidance, *takaful* operators would likely need to consolidate participants' funds that it controls. Control is described in greater detail in the prospective standard, and in future *takaful* operator would need to look to the new consolidation standard to make this determination.

IASB Exposure Draft ED/2010/2, *Conceptual Framework for Financial Reporting: The Reporting Entity*

81 In addition to revised consolidation guidance, the IASB's Exposure Draft, *Conceptual Framework for Financial Reporting – The Reporting Entity* (Conceptual Framework ED) mentions 'combined financial statements' as another type of financial statements, as follows:

> *"Combined financial statements include information about two or more commonly controlled entities. Combined financial statements do not include information about the controlling entity and are often prepared when the controlling entity does not prepare financial reports. Combined financial statements might provide useful information about the commonly controlled entities as a group"*
>
> IASB ED/2010/2, *Conceptual Framework for Financial Reporting: The Reporting Entity*, paragraph RE12.

82 Although this may suggest that combined presentation may be acceptable in future standards issued by the IASB, no indication is given in the Conceptual Framework ED that suggests this could be applied to insurance companies. Additionally, the ED currently does not give detailed presentation and disclosure requirements for 'combined' financial statements. Thus, as of now, it cannot be speculated what the impact of this new type of presentation will be for *takaful* entities.

Tentative conclusions on consolidation and presentation of takaful financial statements

83 As *takaful* entities must comply with MFRS, a *takaful* operator is required to present consolidated financial statements for itself and the participants' funds it controls in accordance MFRS 127.

84 If a *takaful* operator or the relevant regulator believes that information about the separate individual funds is also important to financial statement users, this information and others can be included as additional disclosures. Additional disclosures are not prohibited under IFRS, as long as all the IFRS reporting requirements are met.

Retakaful

85 Re*takaful* is an arrangement whereby, acting on behalf of its participants, a *takaful* operator remits some part of participants' contributions to the re*takaful* pool in return for indemnification of incurred losses through the pool's assets.

86 Under Islamic laws, a *takaful* operator does not get an insurable interest, or the right to reinsure the participants' assets without permission from the participants. However, because a *takaful* operation is usually based on either a *mudarabah* or a *wakalah* principle, the operator has a vested right to re*takaful* participants' assets because permission from the participant is inherent in the contracts of *mudarabah* and *wakalah*.

87 The main purpose of re*takafu*l is to spread the risks of an operator's participants to a pool comprising other operators' participants. It is important to note that a *takaful* operator does not

transfer its participants' risks to the re*takaful* operator. Rather, the re*takaful* operator merely manages the pool.

88 The re*takaful* pooling is sharing of risks of the participants of various *takaful* operators, and this is in contrast with reinsurance where the business is not pooled with other insurers or lines of business[14]. Instead, in reinsurance, an insurer cedes the risks it has accepted from policyholders to a reinsurer.

89 The re*takaful* does not get involved with a loss until a predetermined retained limit of loss or retention, which the *takaful* operator will bear, is exceeded. The re*takaful* operator will usually cover losses up to a specified maximum liability.[15]

Current requirements for retakaful

90 The current IFRS 4 allows entities to apply jurisdiction-specific accounting guidance. In Section 6.2 of the financial reporting guidelines issued by BNM (BNM/RH/GL 004-6), there is a specific statement of its applicability to re*takaful* operators. Thus, re*takaful* liabilities would fall under the same accounting guidance as other *takaful* liabilities.

91 Specific to re*takaful*, section 6.9(a) of BNM's guidelines states that provisions for re*takaful* receivables should be based on all amounts outstanding for more than six months from the date they become due.

Prospective guidance for retakaful

92 Under the proposed revision to IFRS 4, a re*takaful* agent (reinsurer) would account for reinsurance contracts it issues using the same proposed recognition and measurement principles as insurance contracts. Paragraphs 43-46 of the IASB exposure draft on insurance contracts state that at initial recognition, the reinsurance contract would be recorded as the sum of the present value of the fulfilment cash flows plus a residual margin.

[14] Tobiaz Frenz and Younes Soualhi, *Takaful and Retakaful – Advanced Principles and Practices*, IBFIM and Munich Re, Kuala Lumpur, 2010

[15] *Ibid.*

Tentative conclusions on retakaful

93 Generally, re*takaful* operators should account for their transactions under the same guidance as *takaful* operators, in accordance with BNM's *takaful* guidance. In future, it is expected that the revised IFRS 4 would maintain the exposure draft's requirement for a reinsurance contract to be recorded as the sum of the present value of the fulfilment cash flows plus a residual margin.

Participating contracts

94 *Takaful* contracts contain features that allow participants to benefit from surpluses – such as from higher than expected investment performance or lower than expected claims. These features typically take the form of either a retroactive contribution adjustment or a performance clause, and may be considered participating features.

95 Because the participants' funds are held to belong to the participants, if it achieves a surplus, that surplus may be distributed in whole or in part to the participants, and effectively becomes a rebate on contributions paid. The basis on which this will be done may be specified in the policy contract. Part of any surplus may, for example, be retained to build up capital in the fund to cope with future adverse risk outcomes. The prospect that surplus may be distributed is deemed as a significant selling point by some *takaful* operators in selling protection products. Under IFRS, participating features may give rise to unique accounting treatments.

Current requirements for discretionary participation features

96 MFRS 4 defines a 'discretionary participation feature' as follows:

> *"A contractual right to receive, as a supplement to guaranteed benefits, additional benefits:*
>
> *(a) That are likely to be a significant portion of the total contractual benefits;*
>
> *(b) Whose amount or timing is contractually at the discretion of the issuer; and*

> *(c) That are contractually based on:*
>
> *i. The performance of a specified pool of contracts or a specified type of contract;*
>
> *ii. Realised and/or unrealised investment returns on a specified pool or assets held by the issuer; or*
>
> iii. *The profit or loss of the company, fund or other entity that issues the contract."*
>
> MFRS 4*, Insurance Contracts,* Appendix A.

97 The first thing *takaful* operators would have to determine is whether their participation features meet the definition of 'discretionary participation features' under MFRS 4. As most *takaful* participation features are 'at the discretion of the issuer' (criterion b) and are contractually based on 'the profit or loss of the fund' (criterion c), the main tension point centres on whether the benefits are 'likely to be a significant portion of the total contractual benefits' (criterion a). MFRS 4 does not give any guidance on determining what constitutes 'significant'. However, consideration should be given to all possible amounts that could be paid, and compare this to the expected benefits to be distributed.

98 If the participating terms meet the definition of a 'discretionary participation feature', paragraph 34 of MFRS 4 states that insurers have an option to separate any guarantee-like elements from the overall discretionary participation feature. If done, the guarantee would be classified as a liability, and the remaining discretionary participation feature would be either a liability or a separate component of equity (depending on the insurer's accounting policy). If the guarantee is not separated, then the entire discretionary participation feature would be classified as a liability.

99 If however, the terms do not meet the definition of a 'discretionary participation feature', a *takaful* operator would need to refer to MFRS 137, *Provisions, Contingent Liabilities and Contingent Assets* for more guidance. MFRS 137 requires entities to provide for contingent liabilities once they are probable and estimable. Thus, when it is probable and estimable that the *takaful* operator will make a payment related to fund surpluses to participants, it should recognise a liability for that payment.

100 In practice, many *takaful* funds have ‘accrued surpluses’ which had been earned and accrued throughout the financial year. These surpluses equal total assets less total accounting liabilities and technical provisions. In addition to actual surpluses accrued, *takaful* actuaries are required to determine the ‘future expected surplus distribution’. The future expected surpluses represent the expected surpluses over the period of the contract’s term that have not yet been realised. When determining the amount to report as a participating contract or contingent liability, *takaful* operators would focus on measuring and recognising the ‘accrued surplus’, with the ‘future expected surplus distribution’ only to be included in the measurement if it is considered probable and can be measured reliably.

Prospective guidance on discretionary participation features

101 Under paragraph B61(j) of the proposed revisions to IFRS 4, ‘payments to current or future policyholders as a result of a contractual participation feature’, which includes participation features that could result in *takaful* participants receiving reimbursements from the operator, would be included in the calculation of expected present value of cash flows under the fulfilment model approach. Here, in addition to the accrued surpluses, the “future expected surplus distribution” calculated by actuaries would presumably be included in the calculation of cash outflows, as this calculation focuses on expectations.

102 Thus, if a *takaful* operator shares excess contributions with the *takaful* policyholders, the operator should include any expected payments within the current estimate of future cash flows (as part of the fulfilment cash flows method approach) when determining the insurance liability.

Tentative conclusions on participation features

103 For *takaful* contracts that have participation features, the *takaful* operator should look to MFRS 4 to first determine whether the participation features meet the definition of a ‘discretionary participation feature.’ If it does, the requirements of paragraph 34 of MFRS 4 would apply. If not, guidance in MFRS 137 would apply.

Revenue recognition

104 In traditional insurance, insurance providers would recognise the entire premium from a policyholder as income. However in a *takaful* contract, as the insured risks are covered by the participants' funds, some believe that it may not be appropriate for a *takaful* operator to claim the entire contribution received as income. Alternatively, since the *takaful* operator is only entitled to specified fees and profit-sharing gains, only those amounts should be recognised as revenue. The remaining contributions would only be considered 'revenue' for the participants' fund.

Portion of contribution to be recognised as revenue

105 Thus, the accounting question to be answered is what part of the contributions received by the *takaful* operator should be considered revenue for the *takaful* operator's financial statements: the entire contribution amount, or only the amount that can be used by the operator for its own uses (such as service fees and profit sharing percentages).

106 There are currently two views on this matter. Some believe that the entire gross contribution amount should be recognised by a *takaful* operator as revenue, because this would provide information that is comparable to the gross premium recognised by conventional insurers. On the flip side, others believe that only the portion of the contribution that relates to the fees earned by the operator should be recognised as revenue, with the remaining contribution amount being recognised as revenue only in the respective fund statements. Despite differences in opinion with regards to the amount of contribution to be recognised as income, most stakeholders agreed that investment surpluses due to the operator should only be recognised as revenue as they are earned.

Tentative conclusions on revenue recognition

107 The amount of revenue to be recognised is contingent on the type of financial statement being presented. If the *takaful* operator presents consolidated financial statements, consolidating its income, expenses, assets and liabilities with that of the participants' funds, then it would be appropriate to present the

entire contribution amount as the group's income. However, in its separate financial statements, the *takaful* operator should only recognise operator-specific revenues and expenses – separate from amounts attributable to the participants' funds.

108 Additionally, if the eventual revised IFRS 4 maintains its exposure draft's presentation requirements, revenue must be presented based on predetermined 'building blocks'. Under this approach, contributions paid by policyholders would typically be considered 'cash inflows' or income received by the consolidated *takaful* entity. These contributions would then be compared to the fulfilment cost (which is comprised of the expected cash outflows and changes in risk adjustment related to the *takaful* contract) when determining ultimate profit and loss of the insurance contract. This profit or loss would be reported separately as the 'residual margin' on the contract. There is no discussion related to bifurcating contributions based on a shared-risk pooling approach in the separate financial statements of the *takaful* operator and the participants' funds.

Disclosures

109 While AAOIFI does not provide comprehensive recognition and measurement guidance on *takaful* and re*takaful*, it has issued disclosure requirements for Islamic insurance companies which may be useful for financial statements users in making their economic decisions. These disclosure requirements are found in four separate standards issued by AAOIFI:

(a) Financial Accounting Statement No. 12, G*eneral Presentation and Disclosure in Financial Statements of Islamic Insurance Companies* (FAS 12)

(b) Financial Accounting Statement No. 13 *Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies* (FAS 13)

(c) Financial Accounting Statement No. 15 *Provisions and Reserves in Islamic Insurance Companies* (FAS 15)

(d) Financial Accounting Statement No. 19 *Contributions in Islamic Insurance Companies* (FAS 19)

110 While some of these disclosures have been incorporated in

guidance issued by the MASB, others are not.

Additional disclosure requirements by AAOIFI

111 Under FAS 12, AAOIFI requires Islamic insurance companies to disclose basic company information, like the name of the company, formation date, legal form, etc. In addition to the basic information, Islamic insurance companies must disclose significant account policies, asset risk exposure, contingencies, commitments and subsequent events. Many of these disclosures are also required under MASB approved accounting standards and Malaysian regulations. However, certain disclosures under FAS 12 are not currently mandatory in Malaysia. These include: disclosure of unusual supervisory restrictions, the amounts and nature of earnings realised from sources not permitted by *Shariah*, contingencies not recognised in the statement of financial position, and legal and discretionary reserves at beginning and end of reporting period.

112 FAS 13 disclosure requirements focus on how an Islamic insurance company allocates surpluses and deficits among itself and its participants. FAS 13 requires a detailed description on the basis that governs the contractual relationship between policyholders and shareholders (in terms of fund management and investment parameters), how profits and losses are allocated between the participants and the operator, any amendments to the structure of the *takaful* (including changes in the fee structure), prioritization in profit distribution, how the underwriting surplus is calculated and the basis for *zakat* calculations. Other than the disclosure on *zakat,* the remaining disclosure requirements in FAS 13 are not covered under existing guidance issued by the MASB.

113 FAS 15 focuses on provisions and reserves related to *takaful* and re*takaful*. FAS 15, like MASB approved accounting standards, requires disclosures on how the provision and reserve balances have changed during the reporting period. Unique to FAS 15, however, is a requirement for Islamic insurance companies to disclose the party that will be receiving the remaining reserve balances upon liquidation.

114 Finally, the disclosure requirements in FAS 19 relate to contributions received. AAOIFI requires disclosure of the

accounting policies related to participant contributions, including withdrawal or cancellation of a policyholder. FAS 19 also requires companies to disclose the contributions according to insurance segments and type of insurance. These disclosures are currently covered under MASB guidance.

Disclosure of separate fund financial statements

115 In addition to the disclosures above, as discussed in the consolidation section of this Discussion Paper, *takaful* operators may also disclose information about the funds it manages, to enable users to examine the details of the individual funds. The information provided may take the form of separate fund financial statements.

Tentative conclusions on disclosures

116 The IFRS permits additional disclosures when necessary and appropriate. Therefore, *takaful* operators are encouraged to make the additional disclosures discussed above if they enable users to make efficient and effective economic decisions.

117 *Takaful* operators that are required to present consolidated financial statements under IFRS may also disclose details of the assets and liabilities of each individual *takaful* fund.

Appendix A
Explanations of terms used

The following explanations are intended to serve as a guide and may not necessarily capture the complexities of the terms. The translations are merely literal renditions that may not necessarily convey the nuances behind the Arabic terms.

Fatwa
A juristic opinion.

Gharar
A word used to denote elements of a contract which are unknown, uncertain or ambiguous.

Halal
Lawful; permitted by Shariah.

Haram
Unlawful; prohibited by Shariah.

Maisir
A word with connotations of chance, usually equated with gambling.

Mudarabah
(lit., profit sharing)
A form of profit-sharing between a party which contributes capital (***rabb al-mal***, i.e. capital provider) and another which contributes efforts, managerial and/or entrepreneurial skills (***mudarib***, i.e. manager / entrepreneur). Profit from the outcome of the venture is shared between the capital provider and manager / entrepreneur according to a mutually agreed profit sharing ratio, while losses are borne solely by the capital provider, provided such loss is not due to the manager’s/entrepreneur's negligence or violation of specified conditions.

Mudarib
(lit., service provider)
A person or entity providing management contributions to a **mudarabah**-based arrangement.

Qard
(lit., loan)
An interest-free loan. In takaful, a loan made to a **participants’ fund** in order to cover the deficit in that fund after exhausting any contingent reserves. The borrower is formally obligated to repay only the principal amount of the loan and the lender is not entitled to demand any return over and above the principal.

Al-Quran

The sacred text of Islam, which is accepted as the foundation of Islamic law, religion, culture and politics.

Rabb al-mal

A person or entity providing capital contributions to a **mudarabah-**based arrangement.

Retakaful

One of the risk management tools used by takaful operators to transfer part of the risk under a **takaful fund** to another **takaful operator** or **retakaful** operator.

Riba
(lit., excess)

1. *Colloquial usage.* An unjustly high or exorbitant return.
2. *Islamic juristic usage.* (a) Any interest charged on a principal loan amount; (b) A gain arising from the unequal values of certain commodities traded in barter.

Shariah

Islamic laws derived from Al-**Quran** and As-**Sunnah**.

Shariah requirements

Shariah principles, rules and regulations; in Malaysia, as adopted by the Shariah Advisory Councils of Bank Negara Malaysia (BNM) and the Securities Commission, as well as **Shariah** rulings promulgated by the Shariah Supervisory Board of Islamic financial institutions.

As-Sunnah

The acts, sayings and tacit approvals of Prophet Muhammad (peace be upon him).

Ta'awun

The concept of mutual assistance.

Tabarru'

Donation, charity or gift.

Takaful
(lit., insurance)

A fraternal arrangement based on solidarity and mutual assistance (**ta'awun**) under which participants agree to contribute to a common fund for the purpose of mutual financial benefits payable to the participants or their beneficiaries on the occurrence of pre-agreed events.

Participants' fund

The fund in which contributions from

(or Takaful fund) participants are pooled.

Takaful operator The party who manages a **takaful fund**.

Wakalah Entrusting another to act in one’s stead, or as one’s representative, for example in the appointment of an agent to facilitate trade operations.

Zakat Obligatory contribution assessed based on certain assets owned by a Muslim that satisfy certain conditions, and is to be distributed to specified categories of beneficiaries.

Appendix B
Overview of the takaful industry

This Appendix does not form part of the Discussion Paper, and should be read as background material to the Discussion Paper.

Takaful in Malaysia

B1 In 1979, the Malaysian Department of Islamic Development, also known as *Jabatan Kemajuan Islam Malaysia* (Jakim), issued a *fatwa* that life insurance is *haram* as it contains the prohibited elements of *gharar, riba* and *maisir*[16]. This *fatwa* spurred the development of an alternative form of protection that would meet *Shariah* requirements – *takaful*.

B2 A life insurance policy is seen as a sale of protection in return for a premium as consideration. Since the subject of sale – 'protection' – is uncertain, there is excessive *gharar* in the sale, rendering it void. *Riba* in life insurance arises in two ways: firstly, since the value of protection purchased and the amount of consideration (i.e. premium) may not be the same, the difference would be *riba*. The contributions may also be invested in a non-*Shariah* compliant manner, leading to a second source of *riba*. *Maisir* arises when an insurance contract is entered into with a hope of gain, turning the contract into a game of chance or gambling.

B3 The desirable features of *takaful* have helped the industry flourish over the years. In Malaysia, there are currently 11 *takaful* operators and 4 re*takaful* operators licensed under the Takaful Act 1984 (the Act)[17]. According to a RAM Ratings report on takaful[18], Malaysia has the largest *takaful* market in the world: holding an estimated 26% of the global *takaful* assets (RM12.4 billion). The

[16] Jabatan Kemajuan Islam Malaysia (Jakim). *Keputusan Fatwa Muzakarah Jawatankuasa Fatwa Majlis Kebangsaan Bagi Hal Ehwal Agama Islam.* 16 Feb 1979.

[17] Bank Negara Malaysia, *List of Licensed Insurance Companies & Takaful Operators in Malaysia,* http://www.bnm.gov.my/index.php?ch=13& cat=insurance [accessed on 28 October 2009 and 27 September 2011].

[18] RAM Ratings, *Special Report, Taking takaful to the next level: The Malaysian Experience,* April 2011, pp. 2-3.

report also states that within Malaysia, *takaful* funds more than doubled, from RM5.9 billion in 2005 to RM12.4 billion in 2009 (averaging at about 20% - 26% a year from 2004 to 2009). Despite having the largest *takaful* presence, the report clarifies that within Malaysia *takaful* assets only accounted for 8% of its total insurance and *takaful* assets.

B4 The Takaful Act 1984 (the Act) acts as the primary source of regulation for the *takaful* industry in Malaysia. Under the provisions of Section 54 of the Act, BNM 'shall be the Director General of Takaful and shall exercise, discharge and perform on behalf of [BNM], the powers, duties and functions conferred to the Director General'. Under the Act, BNM is authorised to make regulations and rulings considered necessary for the prudential supervision of *takaful* licensees.

B5 With regards to financial reporting, the Financial Reporting Act 1997 empowers MASB to dictate the financial reporting standards applicable to entities under its purview. Nevertheless, MASB would give due consideration to pronouncements issued by BNM in arriving at the appropriate financial reporting requirements for the *takaful* industry.

The international *takaful* industry

B6 From 2005 to 2008, the global *takaful* industry grew by a compound average rate of 39.0% compared to 10.2% for conventional insurance; with Malaysia and Saudi Arabia holding the greatest market share[19].

B7 Although the industry has experienced exponential growth, as of 2009 *takaful* comprises only 0.7% of total Shariah-compliant assets worldwide.[20] This can be attributed to three main factors:

- Insufficient understanding of and familiarity with *takaful* products, mainly due to inadequate publicity and education;
- Scarcity in product availability;
- Market obstacles, including unfavourable regulatory

[19] KFH Research Ltd, produced for Global Islamic Finance Forum, *Islamic Finance Opportunities: Country and Business Guide 2010,* Oct 2010.

[20] *Ibid,* p. 11.

requirements, which increase the cost to provide *takaful* products and stifle innovation[21].

B8 Specific to re*takaful*, since *retakaful* companies are rare, many *takaful* operators work with conventional reinsurers, instead of *retakaful* companies, to manage risk. With that said, "general re*takaful* contributions in the Middle East, South-East Asia and North Africa increased from USD372.7 million in 2003 to an estimated USD1.8 billion in 2009."[22]

Microtakaful

B9 As most *takaful* products have traditionally been designed for and marketed to the middle to high income group, the poor may not be able to enjoy the protection that *takaful* has to offer. It is ironic that the people who need insurance or *takaful* the most are those that cannot afford them. In case of an adverse event, a higher income individual would likely have alternative resources to rely on; but the poor often have no such safety net, and if the affected person is a breadwinner the effect to his or her dependents could be particularly devastating. In response to the needs of the underserved segments of society, a form of protection called micro*takaful* has been introduced.

B10 Micro*takaful* can offer many of the same types of protection as *takaful*; the difference is that micro*takaful* is characterised by lower contributions from participants for lower sums assured and correspondingly lower income to the operator. Participants pay nominal contributions to mutually protect each other against an adverse event. As the risks faced by people differ, so does the type of protection they seek. In Indonesia, a popular micro*takaful* product is designed to settle a participant's debts upon his death[23], similar to credit life insurance; in Pakistan, the key insurable risks are health and accident[24].

[21] *Ibid,* p. 20.

[22] *Ibid.*

[23] Takaful Mikro Indonesia, *Program Asuransi Mikro Syariah,* http://takmin.net/?content=content&&id=13 [accessed on 13 October 2011]

[24] The MicroInsurance Centre LLC, *The Landscape of Microinsurance in the World's 100 Poorest Countries*, pg. 9. Available at

B11 Despite the pressing need to provide protection to the underserved, the growth of micro*takaful* has been rather dismal. The biggest challenge is achieving the volume needed to run a commercially profitable scheme. This is because although contributions are low, the risks are not; and large numbers of participants in a pool can be affected at once[25]. For example, if there is a flood in Pakistan, there is a great likelihood that many of the participants in Pakistan (from farmers, to ranchers and business owners) would have claims resulting from the flood. To surmount this challenge, two contrasting views have arisen regarding the way forward for micro*takaful*:

(a) Diversification by combining schemes exposed to different types of risk or in different geographical locations;

(b) Moving away from a commercial model to a social welfare model[26].

Microtakaful growth through diversification

B12 Risk diversification can be achieved in property micro*takaful* by, for example, combining a scheme protecting against livestock disease with a scheme protecting against crop failure. For example, a goat farmer could participate in a micro*takaful* scheme that would compensate him if any of his goats die from disease. Another farmer participating in another micro*takaful* scheme would be compensated for his rice in case of drought or flooding. If these micro*takaful* schemes were combined, the goat farmer and the rice farmer would be mutually protecting each other. In addition to crops and livestock, micro*takaful* could be used to mutually protect other microfinance ventures (such as mutually protecting rickshaw drivers, small-time tailors, etc.). In a well-diversified micro*takaful* operation, the poor can actually pool their risks and help each other in times of need.

http://www.microinsurancecentre.org/UploadDocuments/Landscape%20study%20paper.pdf [accessed on 13 October 2011]

[25] Goud, Blake. "What Microtakaful Needs to Grow." *Sharing Risk Dot Org.* 27 Feb. 2011. Web. 26 May 2011. <www.zawya.com>.

[26] As discussed during *Takaful Industry: Future Direction and Expansion*, a panel discussion at the Takaful Rendezvous 2011, 6 October 2011, Kuala Lumpur.

B13 Geographical diversification could also be beneficial to the growth of micro*takaful*. In the example in B11, if the pool of participants was limited to just Pakistan, then there may not be enough funds in the pool to cover all losses. If, instead, the funds come from a global pool of participants, then participants in countries where there are no floods would be mutually protecting those who were affected by floods.

Microtakaful as social welfare

B14 The second view, while seemingly radical, actually recalls one of the traditional roles of a *bait-ul-mal*. A *bait-ul-mal* is a state-run institution responsible for the collection of taxes, *zakat* and unclaimed assets, and their distribution to eligible recipients. The primary objective of a state-supported entity would be different from a commercial operator. The latter would focus more on immediate profit margins and commissions, and may fail to see the secondary benefits of a more financially stable population. The state, conversely, would be better suited to provide affordable protection as it is in its interest to develop the welfare of its people.

Microtakaful infrastructure

B15 Regardless of the type of entity, to effectively and efficiently reach out to the masses, a micro*takaful* provider should consider utilising existing infrastructure as delivery channels. This could involve using post offices, village heads or non-governmental organisations (NGOs), *zakat* funds and donor agencies; support from the *takaful* sector should also be obtained in the form of technical expertise and financial assistance.[27] Thus, micro*takaful* entities should work in tandem with *takaful* companies and other bodies to share knowledge and create synergies.

[27] "The Missing Link in Takaful." *Middle East Insurance Review* (July 2008): 56-58. Print.

Appendix C
Types of *takaful* structures

This Appendix does not form part of the Discussion Paper, and should be read as background material to the Discussion Paper.

C1 In February 2004, the Islamic Banking and Finance Institute Malaysia Sdn. Bhd. (IBFIM) prepared an Initial Study Paper on *takaful*, which was presented to MASB Working Group 36 (Islamic Financial Reporting). This paper identified three common structures for Malaysian *takaful* arrangements: *mudarabah*, *wakalah* and a hybrid of both. IBFIM also discussed the results of a simulation exercise, highlighting that the choice of structure would influence a *takaful* operator's policies on management fees charged, and on capitalisation of acquisition costs - resulting in differences to the operators' income. On the other hand, one similarity found was that, regardless of the type of structure, deficits arising from a participants' fund were always funded by *qard* from the *takaful* operator's shareholders' funds.

C2 Globally, there are four types of *takaful* structures commonly in use: *mudarabah*, *wakalah*, a hybrid of *mudarabah* and *wakalah*, and *wakala waqf*. The revenue drivers for each of the structures differ significantly. The four types are explained in the following sections.

Mudarabah structure

C3 In a *mudarabah* model, a principal-manager relationship is created between the participants and the *takaful* operator. The *takaful* operator manages the overall underwriting and investment activities for the participants. The income to the *takaful* operator consists of portions of the underwriting surplus and investment returns. The *takaful* operator as *mudarib* (entrepreneur / manager) does not share in any deficits, as these are passed to the pool participants.

C4 The participants agree to share the underwriting surplus with the *takaful* operator in hopes it would incentivised the operator in to achieve higher returns. However, critics have pointed out that this could also adversely entice the *takaful* operator to expose the *takaful* funds to excessive risks, especially since the operator does not share in any deficits. With that said, in many jurisdictions (including Malaysia) this is mitigated through regulatory requirements to extend financial assistance, e.g. through *qard*, if the pool of funds experiences a deficit. A separate argument against this practice is that some believe the technical result of a *takaful* scheme is not considered a profit, and such *takaful* operators should not be entitled to any underwriting surplus.

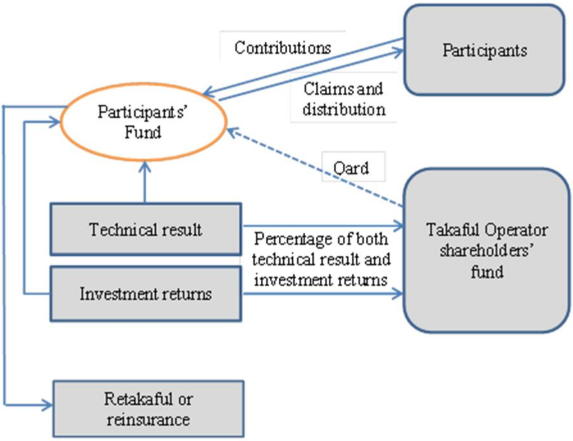
Contributions
Participants
Claims and distribution
Participants' Fund
Qard
Technical result
Percentage of both technical result and investment returns
Takaful Operator shareholders' fund
Investment returns
Retakaful or reinsurance

Figure 1: Mudarabah structure

Wakalah structure

C5 In a *wakalah* structure, a principal-agent relationship exists between the participants and the *takaful* operator for both underwriting and investment activities. As an agent, the *takaful* operator not only manages the scheme, but also acts as a representative on behalf of the participants. Under a *wakalah* structure, the only source of income for the *takaful* operator is the *wakalah* fees, which typically amounts to an upfront percentage of contributions (or premiums paid).

C6 Generally, the *wakalah* fees the *takaful* operator receives are lower than the revenue received in other structures, which is a plus for participants. However, since the *takaful* operator cannot receive any upside related to underwriting surpluses or investment returns, the *takaful* operator does not have any incentive to obtain higher returns for the participants.

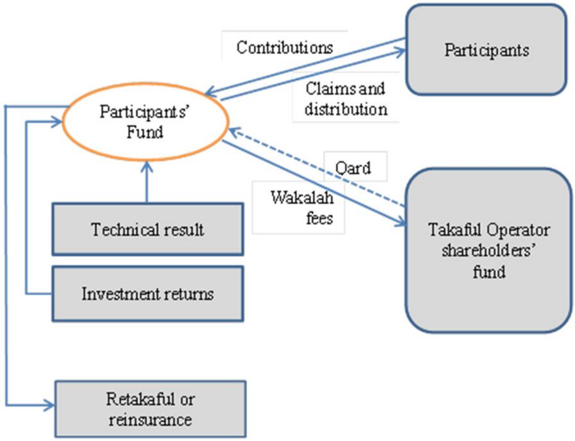
Contributions
Participants
Claims and distribution
Participants' Fund
Qard
Wakalah fees
Technical result
Investment returns
Takaful Operator shareholders' fund
Retakaful or reinsurance

Figure 2: Wakalah structure

Hybrid structure

C7 A hybrid model is a combination of the principal-manager *(mudarabah)* and principal-agent *(wakalah)* arrangements. Here, *mudarabah* is used for investment activities and *wakalah* is used for underwriting activities. This gives the *takaful* operator incentive to achieve higher investment returns, while retaining the underwriting surplus with the participants. Thus, the *takaful* operator's income would be an upfront percentage of contributions for managing underwriting activities, with no further share in the technical results; and a percentage of the investment returns.

C8 Downsides to the hybrid model include the fact that (1) underwriting results could be negatively affected as the *takaful* operator would not share in any surpluses and (2) operators could take on excessive risks with investments since it would not be required to bear any losses.

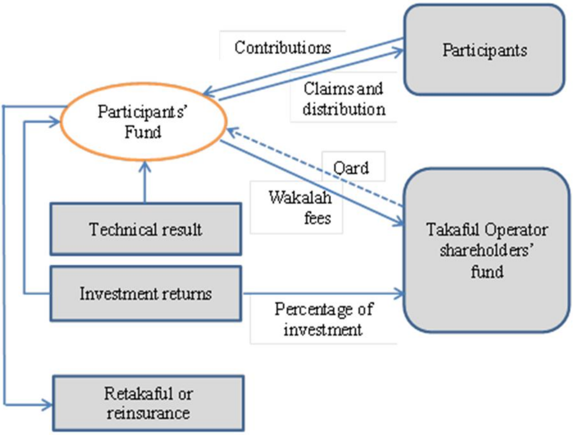
Contributions
Participants
Claims and distribution
Participants' Fund
Qard
Wakalah fees
Technical result
Takaful Operator shareholders' fund
Investment returns
Percentage of investment
Retakaful or reinsurance

Figure 3: Hybrid wakalah-mudarabah structure

Wakalah waqf structure

C9 In a *wakalah waqf* structure, shareholders donate capital to fund a *waqf* fund. This *waqf* fund forms the capital backbone for the *takaful* structure – the money would be invested, with returns channelled into the participants' fund to meet claims. A restriction on the *waaf* fund would be put in place to ensure the donated principal amount would not be used to settle claims (only the investment returns from the principal could be used).

C10 *Wakalah* would be used (similarly to the other *wakalah* structures) to manage the participants' contributions. The *takaful* operator would be entitled to upfront *wakalah* fees for underwriting, and a share in investment returns.

C11 The *wakalah waqf* model is popular in Pakistan. As a note, within Pakistan, Shariah scholars do not allow surplus distribution amongst participants.

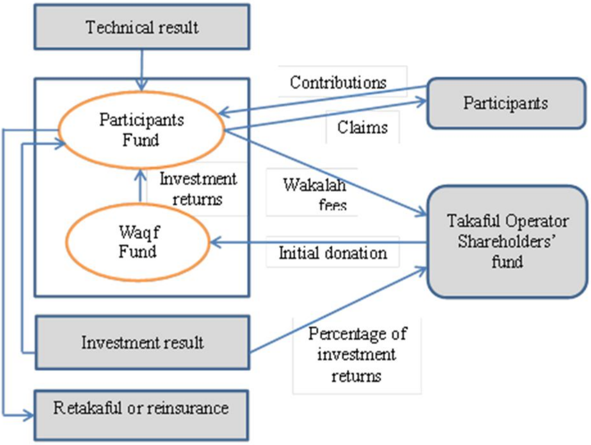
Technical result
Contributions
Participants
Participants Fund
Claims
Investment returns
Wakalah fees
Waqf Fund
Initial donation
Takaful Operator Shareholders' fund
Investment result
Percentage of investment returns
Retakaful or reinsurance

Figure 4: Wakalah waqf structure

Retakaful Model

C12 Similar to conventional insurance, where reinsurance is used to spread insurance risk between various insurance providers, the *takaful* industry has created *retakaful* so *takaful* operators can spread *takaful* risk between various *takaful* operators. Here, the *retakaful* operator plays a similar role to the *takaful* operator. Instead of the participants being individuals or entities who pay premiums for *takaful* coverage, the participants here are various *takaful* operators. The *retakaful* operator's income is limited to the *wakalah* fees and / or profit sharing from mudarabah (depending on the structure used).

C13 Expenses such as claims, acquisition and administration costs are paid out of the *retakaful* contributions received.

C14 *Takaful* operators primarily use *retakaful* to reduce the possibility of deficits in the participants' funds that may trigger a *qard* facility from the *takaful* operator.

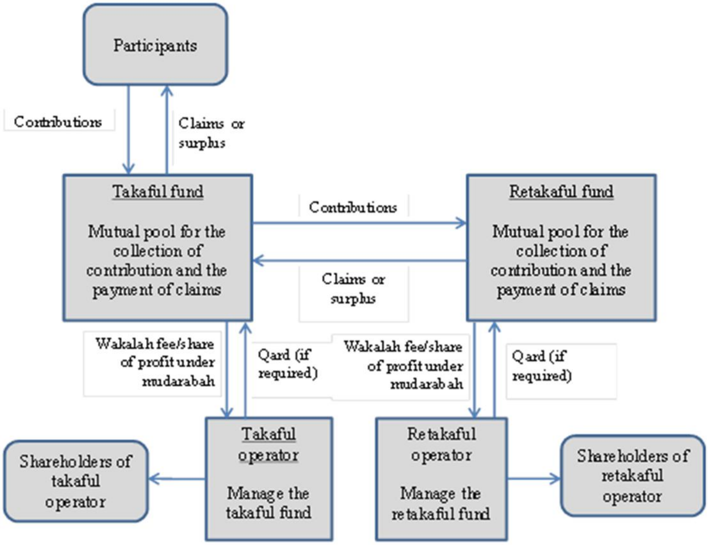
Participants
Contributions
Claims or surplus
Takaful fund
Mutual pool for the collection of contribution and the payment of claims
Contributions
Claims or surplus
Retakaful fund
Mutual pool for the collection of contribution and the payment of claims
Wakalah fee/share of profit under mudarabah
Qard (if required)
Wakalah fee/share of profit under mudarabah
Qard (if required)
Shareholders of takaful operator
Takaful operator
Manage the takaful fund
Retakaful operator
Manage the retakaful fund
Shareholders of retakaful operator

Figure 5: Retakaful structure[28]

[28] Figure 5 is adapted from: Simon Archer, Rifaat Ahmed Abdel Karim, Volker Nienhaus, *Takaful Islamic Insurance – Concepts and Regulatory Issues,* John Wiley & Sons (Asia) Pte. Ltd., 2009, pg. 157.