

2 September 2020<sup>1</sup>

## Issues Bulletin 1

### MFRS 17 *Insurance Contracts*: Definition and Scope for Takaful

Issues Bulletin 1 is issued by the Malaysian Accounting Standards Board as part of its Islamic Financial Reporting research. This Issues Bulletin complements the MASB approved accounting standards and nothing in this Issues Bulletin overrides any specific MASB approved accounting standards.

#### About the Issues Bulletin 1

1. Takaful contracts have been accounted for using MFRS 4 *Insurance Contracts*. MFRS 17 *Insurance Contracts* will supersede MFRS 4 and applies from 1 January 2023. MFRS 17 contains more comprehensive accounting treatments for insurance contracts. Since the definition of an insurance contract in MFRS 17 has been carried forward (unchanged) from MFRS 4, it is expected that MFRS 17 will apply to takaful contracts.

Nonetheless, the MASB Standing Committee on Islamic Financial Reporting has suggested refreshing the discussion on the earlier consensus that MFRS 4, adopted by MASB in 2008, applies to takaful contracts following the issuance of MFRS 17.

2. In reviewing MFRS 17 vis-à-vis a takaful contract<sup>2</sup>, this Issues Bulletin considers the definition of 'insurance contract' and the scope of MFRS 17. It does not include any implementation issues arising from the application of MFRS 17 which may have been brought to the attention of MASB. Those implementation issues are considered by the MASB's MFRS 17 Transition Resource Group.
3. Whilst some argue that MFRS 17 is not specifically designed to cater for takaful contracts, the MASB concludes that takaful falls within the scope of MFRS 17, consistent with the applicability of MFRS 17 to a mutual entity that pools risks into a fund that is distinct from the mutual entity's policyholders.

#### Accounting standards

##### MFRS 4 *Insurance Contracts*

4. Malaysia has a policy of convergence with IFRS Standards and it is also MASB's policy that its approved accounting standards apply to Shariah-compliant transactions<sup>3</sup>. In November 2008, MASB adopted IFRS 4 *Insurance Contracts* as MFRS 4 without an exemption for takaful contracts.

<sup>1</sup> Issues Bulletin 1 was first issued in February 2020. The Issues Bulletin is updated to reflect changes in MFRS 17 as a result of the *Amendments to MFRS 17 Insurance Contracts* issued by MASB on 17 August 2020 (see the revised paragraphs 1, 7 and 15).

<sup>2</sup> As guided by the requirements in BNM Takaful Operational Framework, June 2019.

<sup>3</sup> In 2009, the MASB issued Statement of Principles i-1 *Financial Reporting from an Islamic Perspective* which affirms that MASB approved accounting standards shall apply to Shariah-compliant financial transactions and events, unless there is a Shariah prohibition.

5. MFRS 4 is word-for-word IFRS 4, which was originally issued by the IASB in 2004 as an interim IFRS Standard that:
  - (a) permitted companies to continue their accounting practices to the extent they are not inconsistent with IFRS 4; and
  - (b) focused on enhanced disclosure on the amount, timing and uncertainty of future cash flows from insurance contracts.
6. As such, applying IFRS 4, companies in different jurisdictions adopt a wide range of accounting practices for insurance contracts, largely based on the accounting requirements in each jurisdiction before the adoption of IFRS Standards.<sup>4</sup>

### *MFRS 17 Insurance Contracts*

7. MFRS 17 (amended in August 2020) will be effective for annual reporting periods beginning on or after 1 January 2023. MFRS 17 will supersede MFRS 4. Application of MFRS 17 is expected to:
  - (a) provide users of financial statements with more relevant information about the impact of insurance contracts on an entity's financial position and performance, and provide better transparency; and
  - (b) significantly improved comparability of insurance results because MFRS 17 has its own set of prescribed accounting requirements.
8. As such, local GAAP (generally accepted accounting principles) which has been applied consistent with MFRS 4 needs to be revisited in light of the principles and requirements of MFRS 17. Accordingly, the applicability of MFRS 17 to takaful has emerged as an issue.

### **Definition of Takaful**

9. Islamic Financial Services Act 2013 (IFSA) provides the following definition of takaful:

*“takaful” means an arrangement based on mutual assistance under which takaful participants agree to contribute to a common fund providing for mutual financial benefits payable to the takaful participants or their beneficiaries on the occurrence of pre-agreed events”*

The IFSA also establishes the distinct relationship between takaful fund, takaful operator and takaful participants whereby:

- (a) section 90 requires that a licensed takaful operator establish and maintain separate takaful fund(s).
- (b) section 91 requires a fund established under section 90 to be managed separately from the shareholders' fund.
- (c) section 92 prescribes that the takaful fund established must be maintained and managed by a licensed takaful operator on behalf of and in the best interests of the takaful participants.

---

<sup>4</sup> *Why Change Insurance Contracts Accounting*, IASB, January 2017.  
<https://www.ifrs.org/-/media/project/insurance-contracts/current-stage/educational-materials/why-change-insurance-contracts-accounting.pdf>

10. Whilst takaful refers to an arrangement between takaful participants and a common fund, it is also important to note that, like MFRS 4, MFRS 17 applies to contracts within its scope.

The IFSA defines a takaful contract within the context of a takaful certificate. It states (emphasis added):

*“takaful certificate” includes a takaful cover note or any contract of takaful for family takaful business or general takaful business whether or not embodied in or evidenced by an instrument in the form of a takaful certificate, and references to—*

- (a) *issuing a takaful certificate shall be construed as entering into a contract of takaful, whether or not a formal contract has been issued; and*
- (b) *a takaful certificate of a takaful operator includes a takaful certificate in respect of which the takaful operator is under any liability, whether the takaful certificate was issued by the takaful operator or the liability was transferred to the takaful operator from another takaful operator.*

A licensed takaful operator is defined as follows:

*“a person licensed under section 10 to carry on takaful business and includes a licensed international takaful operator.”*

11. The above establishes that a takaful operator, acting on behalf of a pool of takaful participants in managing the takaful fund, and takaful participants are the legally-contracting parties under a takaful contract. The takaful fund is not a separate legal entity; however, it is distinct from the takaful operator. For the purpose of discussion, it should be noted that, under MFRS 17 a contract is an agreement between two or more parties that creates enforceable rights and obligations. The participants and the takaful fund each have enforceable rights and obligations under takaful contracts and are regarded as contracting parties under MFRS 17.2. That is, each party to an insurance contract has an accounting identity, but may not necessarily be a legal entity. MFRS 17.2 states:

*“An entity shall consider its substantive rights and obligations, whether they arise from a contract, law or regulation, when applying MFRS 17. A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity’s customary business practices. Contractual terms include all terms in a contract, explicit or implied, but an entity shall disregard terms that have no commercial substance (ie no discernible effect on the economics of the contract). Implied terms in a contract include those imposed by law or regulation. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services).”*

## MFRS 17 definition of an insurance contract

12. Current takaful arrangements are designed to offer participants protection that is economically similar to insurance whilst adhering to Shariah principles. The definition of an insurance contract in MFRS 17 is carried forward (unchanged) from MFRS 4. Appendix A of MFRS 17 defines an insurance contract as:

“A contract under which one party (the issuer) 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.”

13. Appendix A further defines the following terms in relation to the above definition:

<b>Insurance risk</b>	Risk, other than <b>financial risk</b> , transferred from the holder of a contract to the issuer.
<b>Financial risk</b>	The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.
<b>Insured event</b>	An uncertain future event covered by an <b>insurance contract</b> that creates <b>insurance risk</b> .
<b>Policyholder</b>	A party that has a right to compensation under an <b>insurance contract</b> if an <b>insured event</b> occurs.  Note: This Issues Bulletin uses the term ‘policyholder’ when referring to conventional insurance and quoting MFRS 17. This Issues Bulletin uses the term ‘participant’ in the context of takaful entities and when referring to the IFSA. Based on this Issues Bulletin’s conclusion, in a takaful context, a participant is equivalent to a policyholder.

14. In the assessment whether a takaful contract meets the definition of an insurance contract, there are two elements in the MFRS 17 definition to consider:
- (a) acceptance of significant insurance risk by one party; and
  - (b) agreement to compensate another party for adverse consequences of an insured event.

Acceptance of significant insurance risk is discussed in MFRS 17 within the context of the party issuing an insurance contract. In a takaful arrangement, legally, the party issuing the contract is the takaful operator. However, the contractual relationship is premised upon the role of the takaful operator as the party that manages a takaful fund in the best interests of takaful participants.

### Acceptance of significant insurance risk

15. Principally, takaful is built on the concept of risk sharing among participants whereby the participants contribute to a fund which would pay for any claim meeting predefined conditions for indemnity by any participant. Following this concept, any claims are funded from the contributions made by all the participants. However, the fund is a separate entity<sup>5</sup> from the participants. Each takaful fund is a pool of funds from all the participants and distributes compensation only to those participants that submit valid claims. Thus, the takaful fund accepts significant risk from participants (as individuals) and compensates participants if they incur an insured loss. In the event of a fund being in surplus at the end of a defined period, that surplus, or part thereof, is returned to the participants. Accordingly, each takaful participant acts:

<sup>5</sup> Under the concept of tabarru’, the takaful fund is collectively owned by the pool of takaful participants based on the resolution by the Shariah Advisory Council of Bank Negara Malaysia (in its 62<sup>nd</sup> meeting dated 4 October 2006).

- (a) in their individual capacity as a customer; and
- (b) together with all other takaful participants in a takaful fund as a fund participant.

The potential for a participant to hold dual roles as both customer and participant is clear from the discussion in IFRS 17.BC269 which states that (emphasis added):

*BC269 The Board noted that to provide useful information about its financial position and financial performance, an insurer that is a mutual entity can distinguish:*

- (a) *in the statement of financial position, the liability attributable to policyholders in their capacity as policyholders from the liability attributable to policyholders with the most residual interest in the entity; and*
- (b) *in the statement(s) of financial performance, the income or expenses attributable to policyholders in their capacity as policyholders before determination of the amounts attributable to policyholders with the most residual interest in the entity.\**

\* *When developing the June 2020 amendments to IFRS 17, the Board noted that some entities described in practice as mutual entities do not have the feature that the most residual interest of the entity is due to a policyholder (see paragraphs BC269A–BC269C). Paragraphs BC265–BC269 describe the outcome of applying IFRS 17 for entities for which the most residual interest of the entity is due to a policyholder.*

16. MFRS 17.B16, in discussing mutual entities, states that:

*‘An entity can accept significant insurance risk from the policyholder only if the entity is separate from the policyholder. In the case of a mutual entity, the mutual entity accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively because they hold the residual interest in the entity, the mutual entity is a separate entity that has accepted the risk.’*

17. The concept of pooling of conventional insurance risk is similar to the pooling of risks in a takaful fund albeit a takaful fund is not the same as a mutual entity, for example in the following aspects:

- (a) a mutual entity is owned entirely by its policyholders without an operator or a service provider (such that the policyholders would enjoy any surplus in the form of dividends or reduced future premiums and absorb any losses or deficits of the funds); and
- (b) a mutual entity is commonly established as a legal entity (unlike a takaful fund that is not a legal entity).

In the same way that MFRS 17 explains a mutual entity accepts insurance risk from its policyholders, it is considered that the mutuality aspect of a takaful fund is consistent with the takaful fund accepting insurance risk from takaful participants. Although the takaful fund is not a legal entity, it can have a separate accounting identity and is a separate party from the participants, accepting significant insurance risk that is pooled collectively for the purpose of meeting takaful claims. In addition, the takaful fund is established to be distinct and separate from the shareholders’ fund (section 91 of IFSA) and each takaful fund is managed separately (paragraph 9.10 of BNM Takaful Operational Framework, June 2019).

As such, although the takaful fund is not the legal entity issuing the contract, it is the party accepting significant “insurance risk” and hence falls within the scope of MFRS 17.

## Agreement to compensate policyholders

18. Another element to the definition of an insurance contract is that the party that accepts significant insurance risk agrees to compensate policyholders when insured events adversely affect policyholders. Conceptually, (1) the principle of takaful is that the participants would contribute to a fund to compensate each other for losses arising from specified risk and (2) the takaful fund as a whole compensates participants in the event of a valid claim (with the takaful operator managing the claims process on behalf of the takaful participants).
19. MFRS 17.B27(b) provides examples of items that are not insurance contracts and are not within the scope of MFRS 17. It states (emphasis added):

*“The following are examples of items that are not insurance contracts: ... contracts that have the legal form of insurance, but return all significant insurance risk to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder to the issuer as a direct result of insured losses...”*

20. On initial reading, the above paragraph might imply that a takaful fund is not within the scope of MFRS 17 as the overarching principle of takaful is risk sharing among the participants. However, a takaful fund is notably different from the description in MFRS 17 of non-insurance contracts because MFRS 17.B27(b) refers to ‘all’ significant insurance risk. The individual participant in a takaful fund may bear some small portion of their own insurance risk because they share in the pool of risk, but assuming there is more than one participant in the takaful fund, each individual could not be said to have all their significant insurance risk returned to them.

In addition, in the event of a loss or a deficit in takaful funds, the takaful operator is ultimately responsible for ensuring the solvency of the funds<sup>6</sup>. The takaful operator may be able to obtain sufficiently high contributions on future takaful policies to recover those losses; however, these cash flows would be beyond the boundary of the existing takaful policies. Those future policies are not relevant to an existing deficit in a fund because existing customers can opt to terminate (or not renew) their contracts if they do not consent to the increased contributions. Accordingly, the takaful operator is not in a position to ‘*return all significant insurance risk to the policyholder*’.

21. Therefore, the takaful fund is the party agreeing to compensate a participant if a specified insured event adversely affects that participant<sup>7</sup>.

## Other considerations

22. There are other indicators that the economic and business risk exposures of a takaful entity are the same as those facing a conventional insurer.
23. On behalf of a takaful fund, a takaful operator undertakes most of the same activities as a conventional insurer; including:
- (a) underwriting;
  - (b) investment management;
  - (c) claims processing, including loss adjusting;

<sup>6</sup> In the event of a deficiency of the takaful fund, section 95 of IFSA requires the licensed takaful operator to provide qard (interest-free loan) or other forms of financial support to the takaful fund from the shareholders’ fund.

<sup>7</sup> Paragraph 15.3 of BNM Takaful Operational Framework, June 2019 states that in the claims handling process, a licensed takaful operator must ensure that claims are paid from relevant funds as stipulated in the takaful certificates.

- (d) marketing and appointment of agents.
- 24. The fact that some or all of these activities might be outsourced to third parties is not relevant. A takaful operator might engage in outsourcing, but the takaful operator remains responsible for ensuring those activities are undertaken on behalf of a takaful fund.
- 25. The structure of a typical modern takaful undertaking comprises a normal shareholder-owned company and ring-fenced takaful funds considered to be the property of the participants. Although the takaful funds generally do not have separate legal personalities, they represent pools of funds with different ownerships and have separate accounting identities under MFRS 17. For financial reporting purposes, the parties to a contract do not necessarily need to be legal entities.

## Conclusion

- 26. MFRS 17 applies to those contracts that fall within the 'insurance contract' definition, regardless of their legal form or the legal form of the entity accepting insurance risk. Accordingly, a takaful fund would fall within the scope of MFRS 17 because a takaful fund (as managed by the takaful operator) is separate from the participants and the fund is accepting significant insurance risk from the participants in the same way that a mutual entity accepts significant insurance risk from its policyholders. In the same way that MFRS 17 regards a mutual insurer as accepting insurance risk from its policyholders (who also hold residual interests in the mutual), it is considered that a takaful fund accepts insurance risk from its participants (who also hold residual interests in the fund).
- 27. In the context of MFRS 17, insurance risk is being transferred from participants to another entity – being the takaful fund (or funds), managed by the takaful operator. The acceptance of significant insurance risk need not be a direct, overt acceptance but may result from the presence of an entity's customary business practices and its substantive rights and obligations when applying MFRS 17 (see MFRS 17.2 above).