

Takaful – Regulatory and Accounting Issues

SECP Seminar on Takaful
14 March 2007

Presentation Background

- The Takaful Rules 2005 were notified on 3 September 2005
- The Rules contain a number of provisions which may lead to some ambiguity in understanding as well as incorrect reporting
- There are also certain accounting and regulatory issues which are not dealt with
 - May therefore result in inequity and mis-reporting
- The purpose of this presentation is to highlight the second set of issues and seek views (from participants) as to the way forward

Presentation Outline

- Pricing and Equity
- General Takaful Issues (Accounting)
 - Recognition of Wakala Fees
 - Accounting
 - By PTF/Waqf
 - By Class of Business
 - Taxation of General Takaful Companies
- Family Takaful Issues
 - Statutory Fund/ PTF – need for multiple
 - Accounting Issues
 - Presentation Issues

General Principles

- Good regulation avoids duplication and builds on existing provisions
- The Insurance Law and Regulations consists of:
 - The Insurance Ordinance 2000
 - The Insurance Rules 2002 (two sets – issued by Ministry of Commerce and the SECP)
 - Various circulars issued by the SECP
- Ideally the Takaful Rules should only provide for areas where there needs to be a difference as compared with conventional insurance
- Hence for Takaful it is important to identify differences and define how this is to be dealt with
 - And also ensure that existing provisions are allowed to be applicable where these continue to make sense

Differences Between Takaful and Conventional Insurance

- The following basic differences between takaful and conventional insurance
 - The need to maintain a separate risk pool from which the takaful operator (insurer) does not make a profit or loss (although the operator does make an interest free loan in the case of a deficit)
 - Although the operator can share in the investment income earned on the assets of the risk pool
 - The risk pool is NOT the property of the takaful operator but a pool held in trust, much like mutual funds in the case of investments
 - The need to invest assets in Shariah compliant investments

Pricing and Equity

- The Takaful Rules are totally silent on perhaps the most important issue with respect to the concept of risk pooling – equity between participants
- The Rules currently do not restrict different products covering similar risks being priced on different bases. For example one could have two different products with a similar risk profile but priced using different risk rates. This is quite common in group life cases in a competitive environment
- Suggest that the rules should be modified to require the Takaful Operator to :
 - have a documented pricing basis (approved by the Appointed Actuary) for the contributions to the PTF, which should include aspects such as
 - loadings for occupational classes
 - loadings based on underwriting
 - ensure that any “discounts” given are from the Wakala Fees and not at the cost of the PTF, or ensure that any surplus distribution mechanism reflects any differences in pricing the risk contributions coming into the PTF

General Takaful – Recognition of Wakala Fees

- Should this be recognized as income upon receipt of premium (common method)
 - Or should this be recognized over time much as earned premiums/ incurred commissions
 - Or should there be a hybrid
 - Based on principle that the charge should be recognized in accordance with the pattern of the incurring of expenses it is meant to cover
- If recognized over time, should the fees be retained within the PTF during the deferral period?
 - If not should there be reserves set up within the Shareholders' Fund

General Takaful – Accounting

- The Accounting Regulations do not deal with the existence of PTFs
 - Require revenue accounts by class of business
 - Also currently class of business specific expenses are accounted for within the revenue accounts
 - In the case of PTFs accounted for within the P&L (Shareholders' Funds)
 - Suggest that to give meaning to the accounts, the expenses in the Shareholders' Fund also be analyzed by class of business.
 - Also provide for deferral of commission expense as in case of conventional non-life insurance
 - Suggest that there also needs to be separate accounting for separate PTFs with class of business accounts within this
- In the case of entities who create Waqfs (under the Wakala-Waqf model)
 - The Waqf is strictly a separate legal entity and therefore should be the subject of separate accounting (much like trust funds for retirement schemes or mutual funds – distinct from the AMC)
 - Accounting regulations needs to be designed to cater to this eventuality

General Takaful Taxation

- The fourth schedule does have a provision which allows the SECP to specify reserves which may be considered for the purpose of determining income subject to tax
- Suggest that the SECP specifically provide for any surplus retained within the PTF as allowable as a deduction in determining taxable income

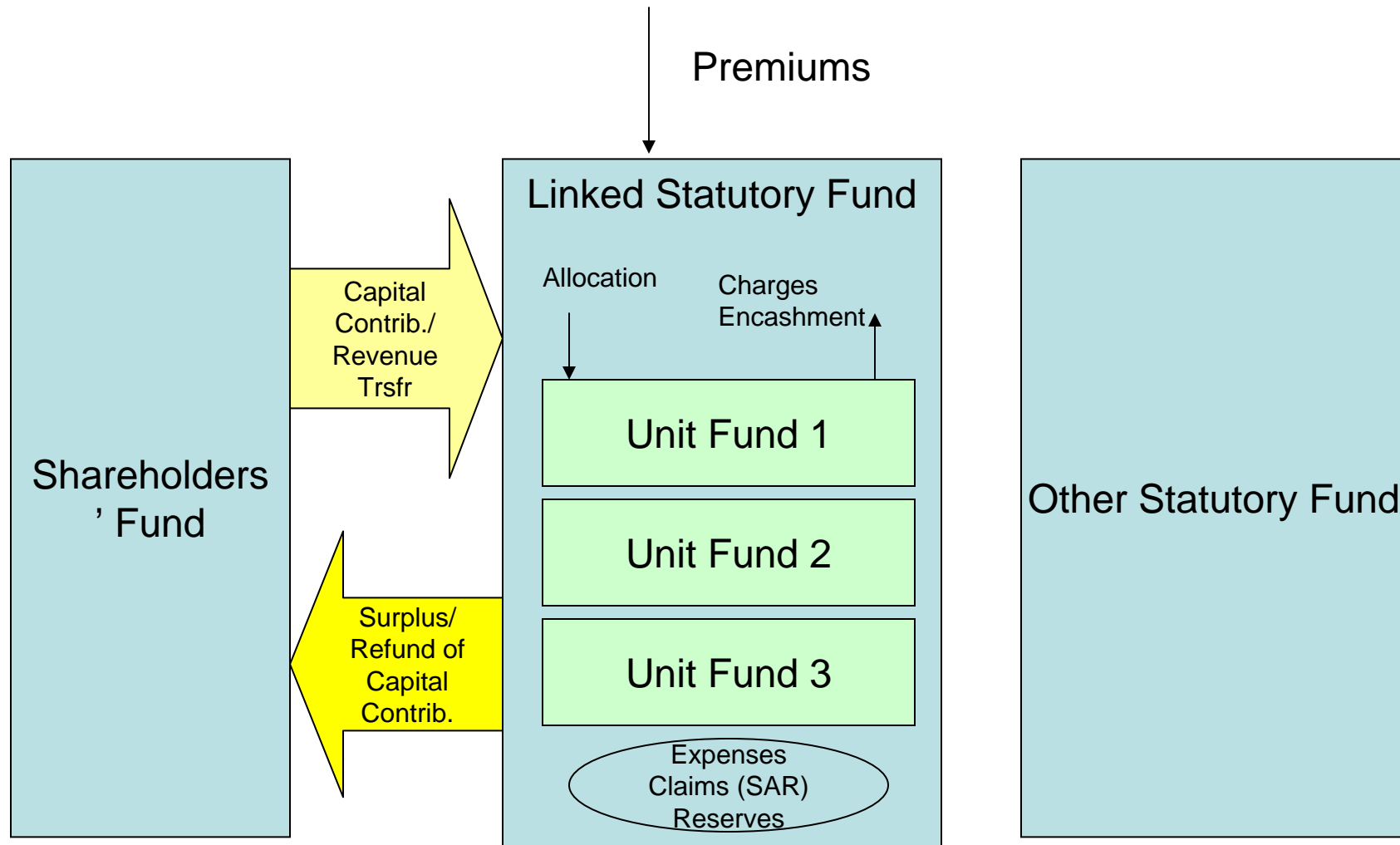
Takaful Business Statutory Fund

- Rule 8(2) seems to restrict a Takaful Operator to opening a single Statutory Fund as it says:
 - “All contributions received under Family Takaful contracts shall be credited to the Takaful Business Statutory Fund”.
- Under S14 of the Insurance Ordinance 2000, separate statutory funds need to be maintained for certain classes of business (eg., pensions or accident and health).
- Also investment linked and non-investment linked (pure risk products such as Group Family Takaful) should be written in separate statutory funds per the Ordinance.
- The rules apparently need to be modified to allow multiple statutory funds, otherwise a Family Takaful Operator will not be able to enter into certain types of business for fear of contravening the provisions of S14 of the Ordinance.

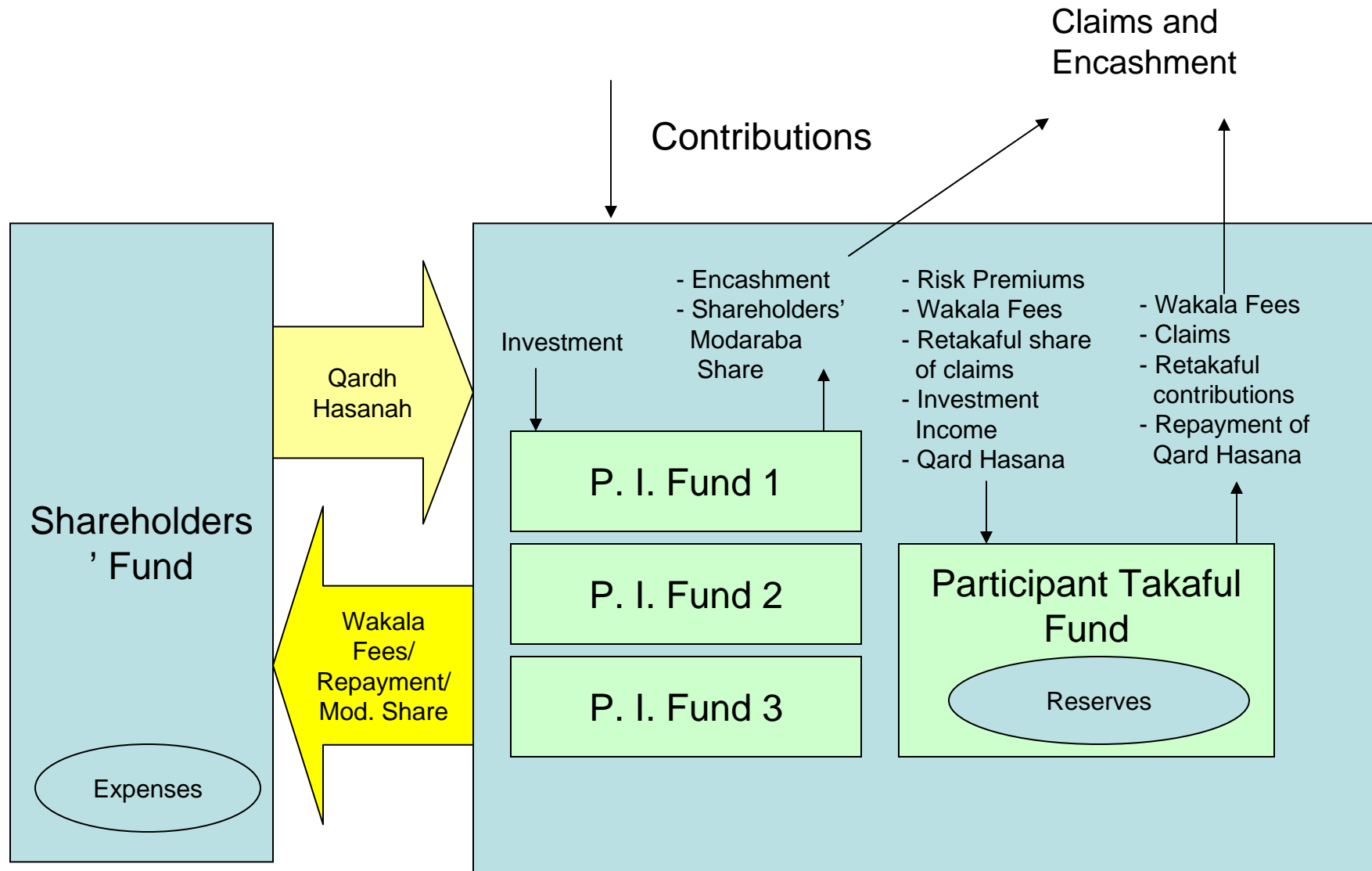
Participant Takaful Fund

- Again Rule 8(3) for Family Takaful Operators provides:
 - “A separate Participants Takaful Fund (PTF) shall be created within the Takaful Business Statutory Fund”
- For General Takaful Operators Rule 8(5) allows more than one PTF but this does not apparently extend to Family Takaful Operators
- There would be a need to maintain separate PTFs for groups of participants with different profit loadings on the risk premiums, eg., group and individual
 - Also possibly separate PTFs for different risks, eg., accidental death, natural disability, accidental disability, etc)
 - Allowing separate Statutory Funds could be the answer
- The objective should be to ensure equity as much as possible, so that any distribution of surplus should be consistent with loadings (explicit or implicit) in risk premiums as well as underwriting practices
- There was a provision in the draft rules for “sub-funds” which was removed in the finalization of the Takaful Rules

Funds – Conventional Life Insurer



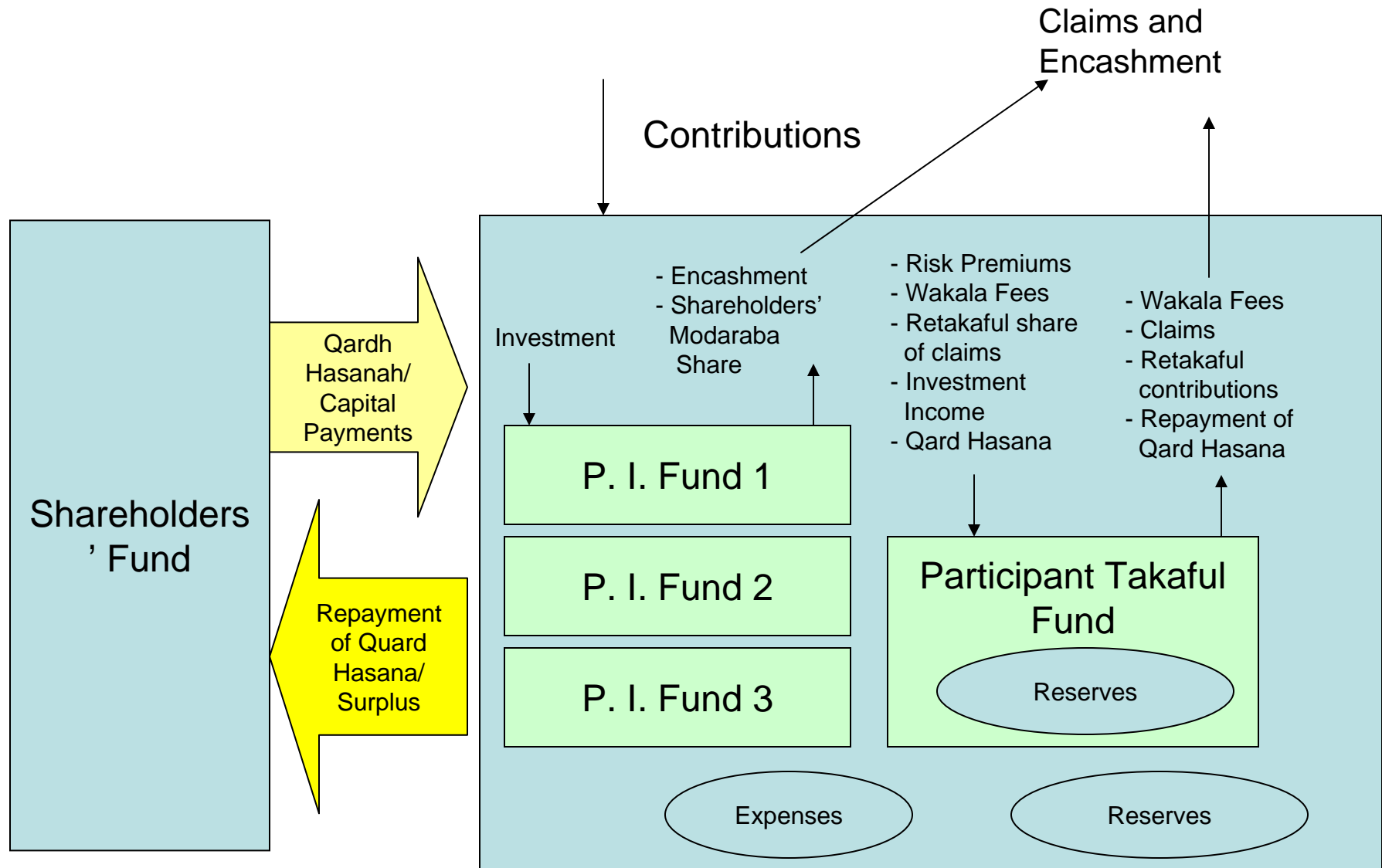
Funds – Family Takaful Operator



Transfers from Statutory to Shareholders' Fund

- The Insurance Ordinance is based around the concept that funds in Statutory Funds are sacrosanct
 - Not allowed to be transferred out except on the recommendation of Appointed Actuary
 - Inter-fund reinsurance not allowed
 - Assets, liabilities, income and expenditure to be kept separate and to be equitable
- The Takaful Rules allow the transfer of wakala fees without any need to refer to the Appointed Actuary (although one rule – 16(3) contradicts all the others)
 - Consider that this is not keeping in line with the concept followed in the Ordinance
 - May also be ultra vires the provisions of the Ordinance
- There may also be a need to reserve a part of the wakala fees to meet future expenses
 - Perhaps not possible as the Appointed Actuary has no “jurisdiction” within the Shareholders' Fund
- Suggest that a concept be followed where the wakala fees stay within the statutory fund

Suggested Fund Flow



Nature of Assets and Solvency

- Assets for Investment of PIFs and PTFs are limited
 - Especially important due to the asset admissibility provisions as per S32 and related rules
- Two important aspects need to be addressed:
 - Mutual funds need to be specified as a separate asset class under S32.
 - Suggest that allow investments in mutual funds up to a higher proportion than equities
 - Also do not apply limit of 50% relating to investment in equities as currently provided under S32(2)(q)

Accounting for Qard-e-Hasana

- As repayment is dependent upon future surpluses arising, this should not be treated as an asset of the takaful operator and liability of the takaful fund.
- Should be treated as a capital payment as per S20 of the Ordinance
 - Rules should specify this
 - Accounting for capital payments already defined in the Accounting Regulations issued per the 2002 Rules
- Amount of Qard should be separately disclosed (i.e., amount of accumulated surplus and amount of qard should be separately shown, making up the balance of the takaful fund).
- For regulatory purpose, qard should be ignored for capital adequacy purposes.

Possible Issues with IFRS4

- There may be a need to set up equalization reserves within the PTF
 - This is required to reduce the likelihood of a deficit arising
- IFRS4 does not allow reserves which are not linked to specific policies
 - Equalization reserves therefore perhaps not possible
- This aspect needs to be looked at carefully for the future (currently IFRS4 not applicable in Pakistan)

Other Inconsistencies in Rules

- Rule 8(2) tends to imply that the investment component of Takaful operations shall be managed under a modaraba contract whereas rule 19 seems to permit either a wakala, a modaraba or a hybrid contract.
- The concept of “Takaful Benefits” is unclear. The definition of Takaful Benefits is as follows:
 - “Takaful benefit includes any benefit, whether pecuniary or not, which is secured by a Takaful policy,...”
 - However Rule 24(2) states (for Family Takaful) – “..no part of the PTF shall be allocated by way of Takaful benefits to participants except with the approval of the Appointed Actuary and out of a surplus of assets over liabilities...”
 - Not clear therefore whether Takaful Benefits include all benefits paid (including claims) or the surplus distributed.

Thank You