

# Key Solvency Requirements for Takaful Operators

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12 July 2011



# IFSB Standard on Solvency Requirements

- Background to the IFSB's paper
- Key principles
- Consistency with regulatory principles applied to conventional insurance

# IFSB Standard on Solvency Requirements

## Main objectives

- To increase the likelihood that a takaful operator can meet its obligations
- To act as an early warning system for regulatory intervention
- To provide a buffer so that the impact of any losses can be limited
- To foster public confidence in the financial stability of the takaful sector

# IFSB Standard on Solvency Requirements

## Scope of application

- The Standard is applicable to all takaful and retakaful operators
- It may apply to takaful windows depending on the discretion of the regulator concerned

# IFSB Standard on Solvency Requirements

## Segregation of funds

- Solvency must be considered separately in relation to each fund
- Mechanisms for providing capital to a Participants Risk Fund (“PRF”)
  - Qard
  - Does a Qard qualify as regulatory capital?

# IFSB Standard on Solvency Requirements

## Seven Key Features for Minimum Solvency Requirements

### Key Feature 1

- The solvency requirements for takaful operators must adopt a total balance sheet approach
  - The solvency requirements must be set out separately for each of the shareholders' fund and the PRF
  - If a Qard is relied on to enable a takaful operator to meet its solvency requirements, it should be set at a sum above the minimum solvency requirement
  - The regulator must be satisfied that the Qard is available

# IFSB Standard on Solvency Requirements

## Seven Key Features for Minimum Solvency Requirements

### Key Feature 1 contd.

- Requirement for the solvency margin reserves in a PRF to cover:
  - Any underestimate of the technical provisions; and
  - Any miscalculation of asset values
- These additional reserves are intended to cover all types of risks faced by the takaful operator:
  - Credit;
  - Market;
  - Underwriting;
  - Liquidity; and
  - Operational

# IFSB Standard on Solvency Requirements

## Seven Key Features for Minimum Solvency Requirements

### Key Feature 1 contd.

- The takaful operator must have sufficient capital in its shareholders' fund to withstand increases in management expenses or reductions in income
- The assessment of capital requirements should take into account:
  - The potential volatility of expenses;
  - The level and volatility of the takaful operator's income
- Unless the regulator is satisfied that other assets for recapitalising the PRF exist, the takaful operator will be expected to offer a Qard out of the shareholders' fund



# IFSB Standard on Solvency Requirements

## Seven Key Features for Minimum Solvency Requirements

### Key Feature 2

- The solvency requirements should be set at a level such that the respective amounts held in the PRF and the shareholders' fund are adequate to meet their respective financial obligations as they fall due
  - The funds should be managed in a prudent way with the aim (over time) of bringing the reserves in the PRF to a level that it becomes self-sustaining
  - If a Qard is available, the undrawn Qard should be ear marked within the shareholders' fund to meet the solvency requirements of the PRF
  - Any investment income from the Qard should belong to the shareholders so long as the Qard remains undrawn

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## Seven Key Features for Minimum Solvency Requirements

### Key Feature 2 contd.

- Regular actuarial appraisals should be carried out into the solvency of a PRF to ensure any Qard facility is adequate
- Solvency requirements need to reflect any limitations in transferability of funds
- Each ring fenced fund should be subject to its own specific solvency requirements
- Participants need to be made aware of any restrictions on the transferability of assets

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## Seven Key Features for Minimum Solvency Requirements

### Key Feature 3

- Solvency controls should be set at both shareholders' fund and PRF levels
- Solvency requirements should be based on four concepts:
  - Minimum Capital Requirement and Prescribed Capital Requirement (PRFs); and
  - Minimum Target Capital and Prescribed Target Capital (Shareholders' Funds)

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## Seven Key Features for Minimum Solvency Requirements

### Key Feature 3 contd.

- Potential consequences of a breach of solvency requirements:
  - Measures to address solvency levels;
  - Measures to protect participants pending the restoration of solvency levels;
  - Measures to enable the regulator to better assess the situation; and
  - Measures to strengthen or replace the management of the takaful operator or strengthen its risk management and governance processes

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## Seven Key Features for Minimum Solvency Requirements

### Key Feature 4

- The solvency requirements should take into account the quality of the capital which is available to absorb losses in different financial stages of a takaful operator
  - Capital is assessed on its availability, permanency and absence of encumbrances
  - Treatment of the Qard facility for solvency requirements:
    - The Qard facility cannot be withdrawn before the PRF is able to meet solvency requirements independently of the Qard
    - The takaful operator must consent that, in any winding-up, it will treat any Qard that has been drawn down as having been donated to the PRF

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## Seven Key Features for Minimum Solvency Requirements

### Key Feature 5

- Takaful operators' risk management must be comprehensive and cover all risks to which the PRF and shareholders' fund are exposed
- Takaful operators operate two distinct set of risks:
  - Their fiduciary responsibility to manage the PRF and to protect the interests of the participants
  - The need to have adequate capital to meet the risks of the business in addition to any capital backing required to meet potential losses e.g. a Qard facility

# IFSB Standard on Solvency Requirements

## Seven Key Features for Minimum Solvency Requirements

### Key Feature 5 contd.

- The approach adopted by the IFSB is to:
  - Determine the economic value of the assets and liabilities; and
  - Calculate the additional capital required to offset the potential impact of each of the identified risks
- This assessment is carried out using modelling techniques to test the ability of the takaful operator to meet its obligations within a defined level of probability

# IFSB Standard on Solvency Requirements

## Seven Key Features for Minimum Solvency Requirements

### Key Feature 6

- Supervisory review processes must assess whether takaful operators have adequate risk management arrangements in place through which the takaful operator can monitor and control the management of assets and liabilities in a coherent manner
  - Regulatory capital is not a sufficient risk mitigant on its own
  - The risk management framework must include appropriate steps to comply with Shariah rules and principles
  - A Takaful operator should perform its own risk and solvency assessment on the PRF and shareholders' fund separately



# IFSB Standard on Solvency Requirements

## Seven Key Features for Minimum Solvency Requirements

### Key Feature 7

- Information regarding solvency requirements for takaful operators that is material and relevant for market participants should be publicly disclosed to enhance market discipline and accountability
  - Strong incentive for takaful operators to conduct their business in a sound way
  - More effective accountability
  - Disclosure in annual report of risk management framework
  - Provides guidance for potential participants

# Our international practice



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