

# New Takaful Framework Under the Malaysian Islamic Financial Services Act

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## Introduction

Takaful industry enjoyed significant growth with an expected of 15–20 per cent growth annually and to reach USD7.4 billion by 2015.<sup>1</sup> Malaysia has achieved significant achievement in the development of its Takaful industry. The first Takaful Company was established in 1985 under the old law the Takaful Act 1984. With the aim of positioning Malaysia as one of the leading Takaful providers globally, until now, Malaysia has eleven Takaful operators with two foreign ownerships and four Retakaful operators with only one local ownership that actively operating and offering numerous products and services in the market.

**Table: Takaful operators and Retakaful operators in Malaysia**

<i>Nº Takaful Operators</i>	
1.	AIA PUBLIC Takaful Bhd
2.	AmMetLife Takaful Berhad
3.	Etiqa Takaful Berhad
4.	Great Eastern Takaful Berhad
5.	HSBC Amanah Takaful (Malaysia) Berhad
6.	Hong Leong MSIG Takaful Berhad
7.	MAA Takaful Berhad
8.	Prudential BSN Takaful Berhad
9.	Sun Life Malaysia Takaful Berhad
<i>D Syarikat Takaful Malaysia Berhad</i>	
II	Takaful Ikhlas Berhad
<i>Nº Retakaful Operators</i>	
1.	ACR Retakaful Berhad
2.	MNRB Retakaful Berhad
3.	Munchener Ruckversicherungs-Gesellschaft (Munich Re Retakaful)
4.	Swiss Reinsurance Company Ltd (Swiss Re Retakaful)

As part of its pro-active regulatory initiative to promote financial stability and compliance to *Shari'ah* and at the same time further strengthen the regulation of Islamic

financial institutions, the IFSA was passed by the parliament and came into force on June 30, 2013. Basically, the IFSA repeals the old Takaful Act 1984 and consolidates the Islamic financial and Takaful services under single legislation. Considering some of the IFSA new requirements on Takaful matters and the inherent issues after its enforcement in 2013 will significantly affect the Takaful industry, this article embarks on a legal analysis of the IFSA 2013 to Takaful sector and highlights its main challenges in several aspects.

## Takaful framework in the IFSA

Consolidation of the Islamic financial and Takaful services under single legislation namely the IFSA was intended to pave way for the development of an end-to-end *Shari'ah* compliant regulatory framework for the conduct of Islamic financial operation in Malaysia. With the coming into force of the IFSA and Financial Services Act 2013, several separate legislations namely the Islamic Banking Act 1983, the Takaful Act 1984, the Payment Systems Act 2003, the Exchange Control Act 1953, the Insurance Act 1996 and the Banking and Financial Institutions Act 1989 were repealed.

With the new framework in the context of Takaful, the IFSA is expected to efficiently facilitate the implementation of Takaful business through comprehensive provisions relating to the enforcement of *Shari'ah* non-compliance risk and to impose statutory duty upon Takaful players to ensure that their aims, operations, affairs, businesses and activities are in compliance with *Shari'ah* principles. Some of the new requirements of the IFSA such as segregation of funds, single licensed takaful business, form of business entity, additional fiduciary duties of the Board of Directors (BOD), *Shari'ah* governance matter, insolvency framework and consumer rights becomes the fundamental core of the IFSA in regulating Takaful sector.

## Takaful funds requirement

For the purpose of promoting more sound financial position, integrity, professionalism and expertise in the conduct of the business, the IFSA imposes additional prudential requirements on Takaful operators with regards to maintenance of various funds, assets and risk management and these include in the matter of funds segregation, compulsory benevolent loan, and restriction on withdrawal.

In term of the takaful funds, IFSA s.91 makes it mandatory for the takaful operator to clearly segregate the takaful participants funds and the shareholders fund. The nature of *Shari'ah* contracts embedded in the takaful business model will be clearly accounted through this requirement.

In the event of deficit in the risk fund, the IFSA imposes the requirement of a compulsory *Qard* (interest-free loan) to every licensed takaful operator.

<sup>1</sup> Bank Negara Malaysia, Islamic Banking & Takaful at <http://www.bnm.gov.my/> [Accessed October 20, 2014].

While this provision is expected to affect the Takaful operators reserve requirement, it indirectly indicates the true spirit of Takaful by inculcating the element of mutual assistance by the shareholders and the Takaful participants.

As part of its prudential framework to protect the interest of stakeholders, IFSA s.94 prohibits a licensed Takaful operator from making any withdrawal from a Takaful fund unless it has complied with such requirements on withdrawals as may be specified by the BNM, the withdrawal does not impair the sustainability of the Takaful fund to meet its liabilities and the interests and fair treatment of Takaful participants, including their reasonable expectations, have been given due regard. The legal implication of this provision denotes that the Takaful operators have additional duty to comply with all sorts of justifications in order to enable them to withdraw the Takaful fund.

### ***Exclusive license for family business and general business***

By virtue of IFSA s.16, a licensed Takaful operator, other than a licensed professional Retakaful operator, shall not carry on both Family Takaful business and General Takaful. This section clearly requires a Takaful operator other than a professional Retakaful operator with a composite license to separate its Family business from its General Takaful business. The firm is given a grace period of five years to split its business into separate entities. Any licensed Takaful operator who fails to comply with this requirement, if found guilty, may be liable to imprisonment for a term not exceeding eight years or to a fine not exceeding 25 million ringgit or both.

Despite the higher cost incurred to split the business into two entities, this new provision is expected to expand the growth of General Takaful business in the long run. As compared to its Family Takaful counterpart, the growth on the General Takaful side is relatively low. Through this provision, several existing composite operators may consider giving up their General License and new players will enter the market. In the meantime, the five-year time frame to split the business offers opportunities to the existing Takaful operators to map out their strategies to ensure profitable growth and sustainable business models while complying the new framework stipulated under the IFSA.

### ***Form of business entity***

The IFSA 2013 requires Takaful operators to be established as public companies. This is governed by IFSA s.287 which stated that the registered Takaful operator under the repealed Takaful Act 1984 which is a private company and is deemed to be a licensed Takaful operator, shall be converted into a public company in accordance with the Companies Act 1965. This requirement considers Takaful operator to be exclusively

in the form of company and therefore excluding cooperative societies and any other business entities which fall outside the framework of the Companies Act 1965.

With this development, all Takaful operators have not only to be a “public” company but must comply with the provision within 12 months from the Appointed Date. IFSA s.2 refers the appointed date as the date for the coming into operation of that provision namely June 30, 2013. The licensed Takaful operators nevertheless may apply to the Minister with the recommendation of the BNM to extend the 12-month time frame. In this regard, the registered Takaful operators must formally apply to the Minister by giving formal notice in writing before the expiry of the 12 months period.

### ***Additional fiduciary duties of the Board of Directors***

The IFSA puts more liabilities to the BOD and these include the duties to oversee and ensure effective internal controls, compliance and risk management. The distinct fiduciary position and duties of the Board of Takaful operators are also clearly articulated under the IFSA. Section 58 provides that the BOD shall, at all times, comply with the internal policies and procedures adopted including internal policies and procedures to implement the standards as specified by the regulatory authority.

The ultimate responsibility for compliance including *Shari'ah* compliance also lies with the BOD. At this point, the BNM not only can specify fit and proper requirements, and has full discretion to determine compliance framework but also has the power to remove BOD including CEO and officer. Another significant provision relevant to the BOD refers to IFSA s.65. It provides that the BOD shall have regard to the interests of the third party consumer namely Takaful participants in carrying out its functions or duties. Contrary to the shareholders value orientation that requires the BOD to maximise the shareholder's profit, the BOD is now has not only to have due regard to any decision of the *Shari'ah* committee but also duty to protect the interest of third party consumers. It is the burden and responsibility of the BOD to balance the interest of shareholders and other stakeholders.

### ***Shari'ah governance matter***

The IFSA incorporates stricter and significant *Shari'ah* related requirements. It is expected that these requirements will further promote strong and vibrant *Shari'ah* governance framework for the Takaful industry. Under the IFSA, the BNM has vast power and authority and this is guaranteed through s.28 that mandatorily required Takaful operators to ensure at all times, its aims and overall operations are in compliance with *Shari'ah*.

As the main actor of ensuring the *Shari'ah* compliance, the IFSA provides clear framework and authorities of the *Shari'ah* Committee (“SC”). The SC of any registered Takaful operators is now having formal governance framework, statutory duties and privileges similar to

actuaries and auditors. IFSA s.28(2) indicates the power of the SC in which any ruling made by them shall be deemed to be a compliance with *Shari'ah* in respect of that aims and operations, business, affair or activity.

The IFSA also imposes strict reporting duty pertaining to *Shari'ah* matters to all licensed Takaful operators. Section 28(3) mandatorily requires the Takaful operators to immediately notify the BNM for any *Shari'ah* non-compliance or potential *Shari'ah* non-compliance reports. Not only that, the Takaful operators must cease from carrying such activities and to immediately submit to the BNM a plan for the rectification, failing which may lead to commit an offence and on conviction, may be liable to imprisonment for a term not exceeding eight years or to a fine not exceeding 25 million ringgit or both. Strict *Shari'ah* requirement and governance framework will significantly affect the business of Takaful operators. Contrary to its conventional insurance counterparts, all the efforts in ensuring *Shari'ah* compliance will surely increase the firm's operational costs and therefore affecting the Takaful market. This will be a great challenge to the Takaful operators in order to remain competitive.

### ***Element consumerism***

One of the main objectives of the IFSA is to provide a greater certainty and build public trust in the system and the enforcement for sustainable growth and development of Takaful industry. Through the IFSA, ethical business conducts are strengthened and at the same time the interest of consumers are legally protected. The element of consumerism embedded in the IFSA will lead to outstanding changes in the industry and set a new benchmark for Takaful practices in the market.

The practices of fair disclosure and accurate information are crucial in Takaful industry. The IFSA translates these important elements by imposing certain disclosure requirements to all registered Takaful operators. Section 141(1) provides that the consumer or client should have the right to be informed and disclose for any contract of Takaful. The Takaful participants may ask any relevant explanatory material or publicity produced or authorised by the licensed Takaful operator. Any person who violated this section may be liable to imprisonment for term not exceeding five years or to a fine not exceeding 10 million ringgit or both.

While the Takaful operators have disclosure duties, under IFSA Sch.9, the consumers are also required to take reasonable care not to make a misrepresentation to the licensed Takaful operators. The Takaful participants must make sure how clear and specific all the information given to enter the Takaful contract. This is to ensure that all the relevant information given by the consumers is correct so that the Takaful operators can come up with a proper Takaful arrangement and the risk that the consumer will take upon signing the contract. As a general rule, it will be a good defense to Takaful operators if there is misrepresentation on the part of customers.

While the IFSA impose duties of reasonable care upon the Takaful participants, it nevertheless limits the defense of Takaful operators in the case of inaccurate answers for the consumer Takaful contracts. Paragraph 10 of the Schedule 9 of the IFSA on Warranties and Representation states that:

“Any representation made before a consumer Takaful contract was entered into, varied or renewed shall not be converted into a warranty by means of any provision of the consumer Takaful contract or of any terms of the variation or of any other contract, whether by declaring the representation to form the basis of the contract or otherwise.”

This provision indicates that the “basis of contract” clause in consumer Takaful contract is no longer relevant or applicable. All registered Takaful operators can no longer argue that an inaccurate answer constitutes a breach of warranty to render a consumer Takaful contract void from its inception. Therefore, the Takaful operators can only void a consumer Takaful contract on grounds of misrepresentation.

### ***Insolvency framework***

Another important requirements stipulated under the IFSA refer to the insolvency framework. The IFSA specifically provides the Takaful framework in the event of winding up of any Takaful operators. This is also a part of pro-active measures to protect the interest of all stakeholders particularly the Takaful participants. In this regard, IFSA ss.212–218 put requirements to all Takaful operators in the form of the valuation of its assets and liabilities of the shareholders' fund and Takaful fund including liabilities in respect of Takaful certificates and the priority of payment.

The IFSA explains that the termination of all Takaful certificates issued by a licensed Takaful operator is effective from the date of the winding up order. In the event of liquidator be appointed, a liquidator of a licensed Takaful operator which is being wound up shall pay in good faith to any of its claimants without requiring strict proof of debt of such claims to facilitate payment. Any issuance of a Takaful certificate by a director, officer, agent or contributory, past or present, of a licensed Takaful operator, which is being wound up after its cessation of Takaful business is prohibited. Specific condition is imposed to Family Takaful business whereby the liquidator of a family Takaful operator is empowered to carry on its existing Family Takaful business with a view to its transfer as a going concern to another Takaful operator.

### **Conclusion**

In conclusion thereof, as it can be seen from the new framework above, the IFSA significantly impact on all licensed Takaful and Retakaful operators in Malaysia in various aspects of its business and operations. The article

briefly explains the key changes stipulated under the IFSA that significantly relevant to Takaful industry particularly in the aspects of Takaful funds requirement, exclusive license for Takaful businesses, form of business entity, additional fiduciary duties of the BOD, *Shari'ah* governance matter, insolvency framework and element of protecting the interest and rights of the consumers.

While the policy makers are expecting positive development through this regulatory initiative and bringing great changes to the Takaful industry to another level, it nevertheless leads to numerous questions and

issues concerning the actual implementation of the IFSA. Strict requirements of the IFSA will surely affect the overall operating costs and definitely will be the disadvantage to the Takaful and Retakaful operators as compared to their conventional counterparts. Having said that, this factor shall not be an excuse for the Takaful and Retakaful operators to move forward. With this legal development, the Takaful industry must be ready to operate within this new framework and more importantly to better understand the application of the IFSA to ensure sustainable growth in the Takaful market.