[Exposure Draft (AGEB 2/2024) of the]

AAOIFI Governance Standard (GS)__

Principles of Assessment of Necessity for Obtaining Conventional Reinsurance by Takaful Institutions

Contents

AAOIFI Governance Standard ___ “Principles of Assessment of Necessity for Obtaining Conventional Reinsurance by Takaful Institutions” is set out in paragraphs 1-34.

Where the context so requires, the use of the masculine gender shall include the feminine gender and the singular shall include the plural and vice versa and the word “person” shall include any institution, corporation, firm, partnership, body corporate or other forms of association. The table of contents and headings do not form part of the text of the standard and are for the purpose of convenience and ease of understanding and may, at times, help in the interpretation of text only.

In particular, this standard shall be read in conjunction with, and interpreted and applied only in the light of, the requirements of AAOIFI Shari’ah standard (SS) 26 “Islamic Insurance” and SS 41 “Islamic Reinsurance”.

Preface

PR1 Significant growth in the Takaful industry has been observed in the last couple of decades. However, the industry still suffers from weak infrastructure that requires organised and coordinated strengthening efforts. Particularly, due to the relatively smaller size of the Takaful sector, there is a shortage of re-Takaful institutions (and their respective capacity) available in the market, particularly in certain jurisdictions / regions. This has led Takaful institutions around the globe to resort to the use of conventional reinsurance on the basis of necessity, a practice that is addressed in AAOIFI Shari'ah Standard 41 "Islamic Reinsurance".

PR2 This approach has been ongoing for some time, prompting AAOIFI Governance and Ethics Board (AGEB / the board) to feel the need for establishing clear guidelines to streamline the governance process and define the internal controls necessary for the purpose of ensuring

Introduction

Overview

IN1 This standard outline the set of fundamental governance principles and internal controls that govern the situations under which a Takaful institution may utilise conventional reinsurance as a means of managing risk on the basis of necessity. It provides the governance principles and internal control requirements of ensure Shari'ah compliance in this respect. This standard applies to all Takaful institutions (including window Takaful institution) and also to re-Takaful institutions in case of retrocession.

Rationale for issuing this standard

IN2 AAOIFI Governance and Ethics Board (AGEB / the board) considered the fact that there is a dearth of availability of re-Takaful institutions (and their respective capacity), particularly in certain markets and regions, and accordingly at times resorting to conventional reinsurance on the basis of necessity (in line with Shari'ah principles and rules, particularly AAOIFI Shari'ah Standard 41 "Islamic Reinsurance") becomes a normal practice. This creates practical challenges and affects the industry's reputation and enhances the risk of Shari'ah non-compliance. On the other hand, not having access to conventional reinsurance under even the "necessary" conditions increases the risk of not managing the business risk properly and eventual failure of Takaful institutions and industry at large. Accordingly, a delicate balance between the same is necessary. Therefore, the board considered the need for development of this standard to address such risks.

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Objective of the standard

1. The objective of this standard is to provide core principles under which a Takaful institution may avail conventional reinsurance, in the event of necessity.

Scope

2. This standard shall be applicable to all Takaful institutions (including window Takaful institutions[1]), needing to avail conventional reinsurance (see paragraphs 22-23), in the event of necessity.

3. This standard shall also apply to re-Takaful institutions and co-Takaful institutions (which further reduce their risks by opting for retrocession conventionally), subject to the extent suitable to their business model and the approval of, and exemption granted by, their respective Shari'ah supervisory boards (SSBs).

4. For avoidance of doubt, it is clarified that the scope of this standard and the term "conventional reinsurance" does not apply to a re-Takaful / Islamic reinsurance / Islamic cooperative reinsurance coverage obtained from an institution that follows a Takaful / Islamic cooperative insurance model approved by its respective SSB or other Shari'ah authority but may not fulfil certain requirements of AAOIFI Shari'ah standards. Availing such coverage shall be subject to a specific approval by the SSB of the Takaful institution and a general approval of the central Shari'ah board (CSB) of the respective jurisdiction, if any.

Relationship with other standards

5. This standard builds upon AAOIFI Shari'ah Sftandard (SS) 41 "Islamic Reinsurance" and SS 26 "Islamic Insurance". It shall be read in conjunction with, and interpreted and applied only in the light of, the requirements of these two standards.

Definitions

6. For the purpose of interpreting and applying this standard, the following short definitions are relevant:

    a. Necessity – in the specific context of this standard, refers to the temporary / time-bound necessity to obtain coverage (or an extent of coverage) from conventional reinsurance by a Takaful institution in order to manage the liabilities of the

[1] A window re-Takaful institution of a conventional reinsurance institution shall be considered a window Takaful institution, and its transactions would be deemed Shari'ah compliant.

participants' Takaful fund, to safeguard the greater interest of the participants at large, provided that:

i. it is not solely or primarily representing the commercial considerations of the institution, such as, to increase market share or the profit of the institution; and

ii. it applies when, and only when, the Takaful institution has exerted all reasonable efforts to avail re-Takaful coverage under Shari'ah compliant modes;

b. Participants' (also referred to as policyholders') Takaful fund (PTF)[2] – is the fund created by (or on behalf of) the participants with the objective to share risk and whose management has been undertaken by the Takaful institution. The fund is entitled to the contributions and returns (if any), subject to direct expenses, provisions and reserves related to the Takaful operations and the surplus (or deficit) arising thereon;

c. Reasonable efforts – in the specific context of this standard, refer to all possible efforts, in the normal course of business, without incurring significantly higher cost[3], while not ignoring any possible opportunities in line with the requirements of this standard;

d. Reinsurance[4] – is a "conventional" contract according to which an insurance company cedes (transfers) part of the risks of its insurance commitments to a reinsurance company. The insurance company, therefore, undertakes to pay to the reinsurance company part of the insurance premium paid by the policyholders, against the commitment of the reinsurance company to bear part of the claims as per an agreement between the two parties;

e. Re-Takaful[5] – is the arrangement among Takaful institutions, on behalf of their respective PTF under management, to devise a mechanism for the avoidance of part of the risks which the PTF may encounter. On the basis of such arrangement, a re-Takaful PTF, which has a distinct juristic personality and independent financial liability, is formed through making contributions out of the PTF as part of the contributions paid by its participants on the basis of Tabarru. The re-Takaful PTF, thus formed, assumes the task of covering part of the risks encountered by the PTF [Explanation: Re-Takaful is the Shari'ah compliant alternative to the conventional reinsurance, having the distinctive characteristic of being based on the same principles of Takaful and mutuality as indicated in SS 26 "Islamic Insurance" and SS 41 "Islamic Reinsurance", instead of exchange of reinsurance premiums. The need

[2] AAOIFI FAS 43 "Accounting for Takaful: Recognition and Measurement"
[3] The term "significantly higher" refers to a percentage of 33% or higher, and, where surplus is shared, its net effect shall be assessed. Determination of this percentage shall be subjective and based on due consideration of the need, as decided by the SSB.
[4] AAOIFI FAS 43 "Accounting for Takaful: Recognition and Measurement"
[5] AAOIFI FAS 43 "Accounting for Takaful: Recognition and Measurement"

for re-Takaful may arise in respect of a Takaful institution due to lack of sufficient capacity to take risks or because of regulatory requirements of risk sharing with regard to the magnitude of the risk in question.];

f. Takaful[6] – is a process of agreement among a group of persons (commonly referred to as participants) to handle the losses resulting from specific risks to which all of them are vulnerable. A process, thus initiated, involves payment of contributions as donations, and leads to the establishment of a Takaful fund that enjoys the status of a legal entity (from a Shari'ah perspective) and has independent financial liability. The resources of this fund are used to indemnify any participant who encounters injury, subject to a specific set of rules and a given process of documentation. The fund is managed by either a select group of participants, or a joint stock company that manages the Takaful operations and invests the assets of the fund, for an agreed fee;

g. Takaful institution[7] – is an entity possessing a license of practicing Takaful (at times also referred to as Islamic insurance) business in line with the requirements of Shari'ah principles and rules. The institution undertakes its operations based on a remunerated Wakala (agency) contract. In addition to managing Takaful operations, the institution also assumes the responsibility of investing the assets of the fund through Mudaraba or investment agency [Explanation: For the purpose of this standard, a Takaful institution includes a Takaful window operation. The notion "Takaful institution", unless the context suggests otherwise, includes the Takaful operator and the participants' funds]; and

h. Takaful operator[8] – in the specific context of this standard, represents the function of the Takaful institution whereby it manages the PTF and the participant investment fund (PIF), and from an accounting perspective, represents the residual part of the Takaful institution duly owned by and representing the equity, rights and obligations of the shareholders (or the principal owners) of the Takaful institution, excluding the PTF and PIF.

Core principles for determination of necessity

Fundamental approach

7. Obtaining conventional reinsurance is impermissible for Takaful institutions. Accordingly, Takaful institutions shall procure re-Takaful coverage only under Shari'ah compliant arrangements[9].

[6] AAOIFI FAS 43 "Accounting for Takaful: Recognition and Measurement"
[7] AAOIFI FAS 43 "Accounting for Takaful: Recognition and Measurement"
[8] AAOIFI FAS 43 "Accounting for Takaful: Recognition and Measurement"
[9] See paragraphs 3/1, 3/2 and 6/1 of SS 41 "Islamic Reinsurance". SS 41 requires that it is permissible to reinsure with Islamic reinsurance, while generally, it is impermissible for Takaful institutions to reinsure with conventional reinsurer except in the case of necessity. It further requires that Takaful institutions should reinsure to the largest possible extent with Islamic reinsurer(s).

8. Notwithstanding the generality of paragraph 7, obtaining conventional reinsurance may, and shall only, be allowable in case of temporary / time-bound necessity, as determined in line with the Shari'ah principles and rules and the requirements of this standard. Such approval shall be granted by the SSB of the Takaful institution, on a specific, time-bound, case to case basis, in line with the requirements of the respective AAOIFI SS[10] and the principles contained in this standard.

Factors for assessment of necessity

Exhausting all possible Shari'ah compliant options first

9. Procuring conventional reinsurance is Haram and may lead to a breach of trust of the common participants of Takaful institutions and the Takaful industry, in addition to being a significant reputational risk. Therefore, the assessment of necessity shall be performed carefully on a prudent basis and conventional reinsurance may only be resorted to after ensuring that all possible Shari'ah compliant options have been exhausted.

Difference of rate and other commercial considerations

10. In no case shall the difference of rate or other similar commercial considerations[11] be the sole or primary justification for availing conventional reinsurance by a Takaful institution.

Effect of rating on the decision for conventional reinsurance

11. Where a re-Takaful option is available with re-Takaful institutions having a rating less than the desired[12] rating, a decision to revert to conventional reinsurance shall only be taken strictly after considering the following factors:

    a. where the ratings of such re-Takaful institutions are not within acceptable limits as per regulatory requirements (and if exemption from such regulatory requirements is not possible) – conventional reinsurance may be obtained, strictly on the basis of necessity; and

    b. where the ratings of such re-Takaful institutions are less than the desired rating but within acceptable limits as per regulatory requirements (or where exemption may be possible) – conventional reinsurance shall not be obtained.

12. In the event the decision has been made to take conventional reinsurance instead of re-Takaful, in line with the provisions of paragraph 11, in the best interest of the participants, it is preferable that the conventional reinsurance company has a reasonably better rating as compared to such re-Takaful institution.

13. Obtaining re-Takaful coverage shall be preferred even if the re-Takaful institution has a lower rating compared to the available conventional reinsurance options, provided that

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[10] See paragraph 3/2 of SS 41 "Islamic Reinsurance"

[11] In the context of this standard, the term "commercial considerations" refers to the relatively high cost of re-Takaful as compared to conventional reinsurance, and not the financial viability of the re-Takaful institution itself.

[12] In the context of this standard, the term "less than desired ratings" refers to either a direct restriction as the minimum allowed by the regulatory and supervisory authority (RSA), or an indirect restriction within what is permitted by the RSA but increases the solvency requirement.

rating of such re-Takaful option is within the risk appetite of the Takaful institution. In the absence of any regulatory requirement (see paragraph 11(b)).

Retention of risk

14. A Takaful institution, in no case, shall work just as a conduit for conventional insurance / reinsurance.

15. A Takaful institution shall ensure a minimum extent of reinsurance with conventional insurance companies. Such minimum extent shall be commensurate with:

    a. the regulatory requirements for minimum reinsurance coverage for the specific insurance business, where applicable; and

    b. the Takaful institution’s strategy considering the regulatory requirements related to solvency and capital maintenance.

16. Accordingly, a Takaful institution shall retain a reasonable percentage of the underlying risk, particularly in the case of treaty reinsurance. Such retention of risk shall be in the following ranges:

    a. in normal cases, preferably not less than 51%, but in no case less than 33% (excluding excess of loss policies); and

    b. in newly launched Takaful institutions and business lines (for the first three years of operations), and the business lines not covered by re-Takaful institutions, not less than 15% (excluding excess of loss policies).

17. In all cases, net reinsurance premium (net of any discounts) shall not be higher than the amount of net Takaful contribution less applicable Wakala fee.

Use of co-Takaful

18. Exerting all reasonable efforts, for the purpose of application of the principles of this standard, Takaful institutions shall include use of co-Takaful, before resorting to conventional reinsurance. [Explanation: If other Takaful institutions in the jurisdiction have the capacity to cover a proportion of the risk (directly through retention or indirectly through unutilised re-Takaful limits available, then this option shall first be utilised. This is necessary to ensure that the purpose of availing conventional reinsurance is not just to increase the market share, but actually to cover the risks which are not possible to be covered under Shari’ah compliant modes.]

Party to the contract

19. In case of resorting to the conventional reinsurance, the party to the reinsurance contract shall be the PTF, and not the Takaful institution.

Period of coverage of conventional policies

20. A Takaful institution shall ensure that in all cases the period of reinsurance arrangement shall not exceed the actual need and shall strictly be time-bound.

21. The period of coverage for conventional reinsurance arrangements shall correspond with an approved transition plan (see paragraph 25 (b)).

Additional considerations in case of windows Takaful institutions

22. A window Takaful institution shall not resort to a specific reinsurance company in order to enjoy commercial benefits through increased business by combining the reinsurance business of the window Takaful operations with the reinsurance business of conventional parent's insurance operations.

23. The SSB of a window Takaful institution shall exercise a more prudent approach towards allowing the use of conventional reinsurance, on the premise of necessity, considering that:

    a. the reputational risk for the window Takaful institution and the Takaful industry shall not increase by such relaxation; and

    b. in view of the requirements of paragraphs 14-17, a window Takaful institution shall have a reasonable retention of the Takaful risks and shall not function merely as a conduit.

Treatment of transactions and balances with conventional reinsurance

24. Where a Takaful institution avails conventional reinsurance facilities, the following conditions related to transactions and balances shall be met at all times:

    a. any interest-bearing cash reserves, as well as, interest-bearing balances with conventional reinsurance companies shall not be kept, insofar as practicable. In the event of the same being inevitable, any interest income shall be paid to charity;

    b. it is impermissible to receive a reinsurance commission from the reinsurance company (either for the PTF or for the Takaful institution). However, a discount in reinsurance premiums may be sought, which shall be credited to the PTF only;

    c. it is impermissible to receive a reinsurance surplus distribution (or bonus) from the reinsurance company (either for the PTF or for the Takaful institution). However, a discount in reinsurance premiums may be sought, which shall be credited to the PTF only;

    d. a Takaful institution may recover, for its shareholders' fund, an amount up to the actual administrative costs incurred in acquiring a conventional reinsurance policy, in case where such responsibility is not already included in the responsibilities against under the Wakala fee; and

    e. any necessary payments to reinsurance company, whose delay may cause payment of interest, shall be paid in time to avoid payment of interest in any form.

Governance and control requirements

Authorities and responsibilities

Those charged with governance (TCWG)

25. TCWG of the Takaful institution shall cause to develop, approve, supervise and monitor the following:

    a. a strategy whereby it may be appropriately documented, in line with the requirements of this standard, as to how and to what extent the Takaful institution may acquire conventional reinsurance coverage, in the event of necessity; and

    b. a strategy and time-bound transition plan whereby the Takaful institution shall ensure the termination of availing conventional reinsurance, preferably within a period of three years, but in no case more than a period of five years (or as defined by the respective RSA).

Management

26. The management shall develop and be accountable for the implementation of the strategies as required in paragraph 25. In no case shall the management may exceed the limits specified in such strategies, in respect of availing conventional reinsurance coverage.

27. The management of the Takaful institution shall maintain and submit to the SSB appropriate documentary evidence that, despite reasonable efforts, it could not obtain re-Takaful arrangements for certain risk(s). It shall provide prompt and unhindered access to the SSB in respect of all the information required for this purpose, including in particular, all correspondence and other evidence with the re-Takaful institutions and conventional reinsurance providers to substantiate the management's claim.

SSB

28. Before providing a specific, time-bound, transition-based approval to avail conventional reinsurance coverage on the premise of necessity, the SSB of a Takaful institution shall consider as to how, and to what extent, the management of the Takaful institution can justify that it has exerted all reasonable efforts to avail re-Takaful coverage before resorting to conventional reinsurance, including assessment of the factors such as:

    a. are there any regulatory requirements in this respect, and what is the effect of the same while considering necessity?

    b. how many rejections by re-Takaful institutions can be evidenced?

    c. how much re-Takaful coverage is rejected by the Takaful institution due to rate difference or unsatisfactory rating?

    d. what data and analysis are available with regard to market factors?

    e. have all possible avenues been evaluated, including an assessment of peers' approach?

f. what is the process of assessment of necessity at the industry level?

g. what efforts are not exerted, or avenues not evaluated, considering the costs or other commercial considerations?

h. how it can be evidenced that the retention of risks beyond those proposed by the management is not practicable / feasible?

i. to what extent is the transition plan being adhered to?

29. The SSB of a Takaful institution shall not be influenced by the exaggerated threat of loss tendency[13] and shall base its opinion on objective analysis and facts, in line with the requirements of this standard.

Periodic reviews and renewals

30. A Takaful institution shall ensure that the conventional reinsurance arrangements are reviewed periodically (at minimum, annually) by the TCWG, as well as, the SSB of the Takaful institution in order to ensure that all the factors considered earlier are still relevant for the continuity of the necessity assertion in line with the transition plan.

Transparency and disclosure

31. A Takaful institution shall ensure adequate disclosure to all relevant stakeholders, generally through disclosure in the annual report (unless otherwise required by the respective RSA), with regard to the extent of use of conventional reinsurance arrangements, as well as, the transition plan to eliminate the same.

32. The SSB of a Takaful institution shall include a specific opinion in its annual report with regard to the extent of use of conventional reinsurance arrangements, under the necessity assertion, and its comments on the transition plan being executed by the management to eliminate the same.

Effective date

33. This standard shall be effective on or after 1 January 2027. Earlier application is encouraged.

Transitional provisions

34. The requirements of this standard, with regard to the retention of risk as contained in paragraphs 14-17, may follow a transition approach whereby a necessary or appropriate relaxation for a period, not exceeding three years, from the effective date of this standard may be allowed to fully comply with such requirements of this standard.

[13] See paragraphs 50-51 of GS 18 “Shari’ah Decision-Making”

Appendices

Appendix A: Adoption of the standard

This standard was presented for the approval in the AAOIFI Governance and Ethics Board's meeting No. ___________held on ___________H, corresponding to ___________ and was duly approved.

Members of the board

1. Mr. Farrukh Raza (chairman)
2. Dr. Walid Hegazy (deputy chairman)
3. Mr. Abdullah AlMoqbel
4. Dr. Abozer Magzoub
5. Prof. Dr. Ashraf Md. Hashim
6. Prof. Dr. Engku Rabiah Adawiah
7. Mufti Irshad Ahmad Aijaz
8. Mr. Iyad Asali
9. Dr. Mohamad Qaseem
10. Prof. Dr. Mohammad Kabir Hassan
11. Prof. Dr. Necmettin Kızılkaya
12. Mr. Saleem Ullah
13. Mr. Sohaib Umar
14. Dr. Umar A. Oseni
15. Mr. Walid Alzahrani
16. Dr. Zahid ur Rehman Khokher

Reservation

The standard was approved unanimously.

Committee members

1. Mufti Irshad Ahmad Aijaz (chairman)
2. Dr. Ali Saratawi
3. Dr. Ashraf Khan
4. Mr. Ezamshah Ismail
5. Mufti Hassan Kaleem
6. Mr. Hassan Scott Odierno
7. Mr. Kashif Siddiqui
8. Mr. Kazi Md. Mortuza Ali
9. Mr. Lukman Hasan
10. Mr. Mahomed Akoob
11. Dr. Mohamed Fairooz Bin Abdul Khir
12. Mr. Mohamed Hareez Sulaiman
13. Dr. Mohammad Kabir Hassan
14. Prof. Dr. Necmettin Kızılkaya
15. Mr. Nizar Mashal
16. Mr. Ronald Rulindo
17. Dr. Suleiman AlJewissir
18. Mr. Tarig Khalil Osman

Executive team

1. Mr. Omar Mustafa Ansari (AAOIFI)
2. Mr. Farhan Noor (AAOIFI)
3. Ms. Zahra Jassim (AAOIFI)
4. Ms. Alyaa Adel (AAOIFI)
5. Ms. Merjan Abid (Consultant-researcher)

Appendix B: Basis for conclusions

BC1 To be updated.

Appendix C: Brief history of the preparation of the standard

H1 Considering the need in the market and challenges and concerns raised by certain stakeholders, the secretariat proposed developing standards on the Takaful governance during the 35th meeting of AAOIFI Governance and Ethics Board (AGEB / the board) held on 26 Sha'aban 1445H, corresponding to 7 March 2024. The members agreed that there is a need in the market and approved the initiation of the work.

H2 Following the approval of the board, the development process of this standard started. During July 2024, a specific Takaful governance committee was formed which included 18 experts from different backgrounds and parts of the world.

H3 The committee held two meetings to discuss the exposure draft of the standard on 25 Muharram 1446H, corresponding to 31 July 2024 and 3 Safar 1446H, corresponding to 7 August 2024.

H4 AGEB held its 38th meeting on 8 Rabi' I 1446H, corresponding 11 September 2024, via video conference. The members reviewed the exposure draft of the standard and directed the secretariat to make the necessary changes in light of their comments and recommendations. The board approved the issuance of the exposure draft. After due process, the exposure draft was issued on 25 Jumada II 1446H, corresponding to 26 December 2024.