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THE UNITED KINGDOM: REGULATORY APPROACH TO TAKAFUL

Introduction

Since the establishment of the first Islamic insurance company in 1979, the Takaful market, in line with other types of Shariah-compliant financial products, has experienced significant growth. Moody's rating agency has identified that there are currently over 250 Takaful companies in existence worldwide and projections show that total Takaful premiums are likely to reach over USD 7 billion in ten years time.

Although there has been a considerable growth in the use of Takaful products over recent years, the regulation of Takaful remains in its infancy in many jurisdictions, with some favouring the use of one Takaful model over another. In this article, we outline the basic structure of the different Takaful models in operation and, against this background, consider the main features of the relevant legal and regulatory framework in the United Kingdom (the "UK"). The issue is particularly topical at the present time since an increasing number of 'global players' in the insurance market are obtaining licences to operate Takaful companies. In the last two months, Hanover Re and AIG have both been granted Takaful licences to operate in Bahrain and, similarly, Munich Re has recently entered the Takaful market in Malaysia. In line with the current trend, the UK's financial regulatory body, the Financial Services Authority ("FSA"), is in the process of authorising its first Takaful operator. The focus of this article will therefore be on the development of Takaful in the UK and an examination of the FSA rules relating to:

(i) conduct of business;
(ii) capital adequacy;
(iii) management, systems and controls;
(iv) disclosure; and
(v) passporting.

Takaful Models

"Wakala" and "Mudarabah" are the two main Takaful models. In each case, the operator is responsible for developing the products, underwriting the risk, collecting the contributions, investing such contributions and dealing with claims. There has also been a significant growth in the use of a "mixed" model, which combines aspects of Wakala and Mudarabah. The main features of each model are set out below.

The Wakala Model

In the Wakala model, cooperative risk-sharing occurs among participants who contribute to a general Takaful fund. The operator acts as the agent (or *Wakeel*) of the participants and is consequently entitled to a fee for the services provided. Such a fee is deducted from the general Takaful fund or the investment profits derived from investing the general Takaful fund, which may be performance related and for which the operator may charge a performance incentive fee. However, the agent does not share in any underwriting surplus or profits which will be distributed exclusively to the participants.

The Mudarabah Model

In the Mudarabah model, on the other hand, the operator is entitled to a fixed percentage of any investment profits or surplus, which will be paid into the participants' Takaful fund. Generally, these risk-sharing arrangements allow the operator to share in the underwriting results from operations as well as the favourable performance returns on invested premiums. However, the operator's fixed percentage is not guaranteed as there may be no surplus.

The Mixed Model

The mixed model is widely practiced by Takaful companies around the globe and is currently the dominant model in the Middle East. The mixed model combines elements of the Wakala and Mudarabah models and is structured so that the Takaful operator retains two funds; one for the shareholders and the other for participants. The underwriting activities are conducted by reference to the Wakala model, whereby the shareholders manage the funds as agent on behalf of the participants. In exchange for managing the funds, each participant is charged a Wakala fee, which is normally a percentage of the contribution paid by each participant. As an incentive for effective management, the operator is also entitled to earn a fee if there is a surplus in the participants' fund. With regard to investment activities, the operator invests the surplus contributions in different Islamic compliant instruments based on the Mudarabah contract. The operator acts as the investment manager or Mudarib on behalf of the participants and the ratio of profit is fixed and agreed between the parties at the inception of the contract.

The Accounting and Auditing Organisation for Islamic Financial Institutions recommends the adoption of the mixed model. Indeed, the Central Bank of Bahrain (formerly the Bahrain Monetary Agency) has only allowed Takaful operators in the Kingdom to adopt the Wakala and mixed models.

Regulation in the UK

Introduction

Although Lloyd's of London launched its first Takaful syndicate in early 2006, the FSA has yet to authorise a Takaful operator in the UK and, as such, has not commented to any great extent on the subject. However, in discharging its general functions, the FSA must have regard to, amongst other matters, the desirability of facilitating innovation in connection with regulated activities, the international character of financial services and markets and the desirability of maintaining the competitive position of the UK. For these reasons, it is therefore assumed that, although the FSA may be relatively unfamiliar with Takaful as a product, the FSA will welcome any application for authorisation to conduct Takaful business in the UK. The general policy adopted in relation to the regulation of Islamic products has been summed up as "no obstacles, no special favours". This sentiment reflects the FSA's general aim to promote a level playing field between conventional and Shariah-compliant providers. It has been stressed that the FSA is intended to be a financial, not a religious, regulator and, against this background, it would appear that the FSA intends to treat applications for authorisation of a Takaful operator on the same basis as those made by a conventional insurer. Unlike jurisdictions such as Bahrain, there appears to be no intention on the part of the FSA to enact separate regulations for Takaful. It is therefore evident that, within the UK's existing insurance framework, an application for authorisation of a Takaful operator must meet the same criteria as an application by a conventional insurer.

The regulation of insurance in the UK is governed by the Financial Services and Markets Act 2000 ("FSMA"), which came into force in December 2001. FSMA provides that authorisation by the FSA is required in respect of any person carrying on, or purporting to carry on, a regulated activity by way of business in the UK where such regulated activity is in respect of a specified investment (unless the person carrying on such activity is exempt[1]). A specified investment includes rights under a contract of insurance and, similarly, regulated activities include effecting or carrying out contracts of insurance[2]. The question of whether the business element is present will be one of judgment taking into account several factors, none of which is likely to be conclusive. However, it is worth noting that in terms of geographical scope, a Takaful operator could be deemed to be 'carrying on business in the UK' for the purposes of FSMA even though it may not be based in the UK. This would be the case if, for example, the Takaful operator transacts business by making an occasional visit or phone call to the UK or it has established a web site which is accessible from the UK. The scope of FSMA is clearly wide in this regard.

In the absence of a statutory definition of "contract of insurance", case law has identified the following essential elements:

(i) there must be a promise from the insurer to pay money (or money's worth) to the insured in the event that the insured suffers an insured loss;
(ii) the insured must have an insurable interest (i.e. a pecuniary interest) in the subject matter of the policy;
(iii) what the insured purchases is the right to receive money (or money's worth) on the occurrence of an uncertain event (the key feature being that there must be an element of contingency, either as to the occurrence of the event or as to its timing); and
(iv) there must be a premium passing between the parties.

Under English law, a "contract of insurance" is subject to the doctrine of "utmost good faith"[3], which imposes a duty of full disclosure on the parties to the insurance contract[4]. This doctrine is also strongly advocated in Islam as one which should strictly be adhered to as a way to prohibit all parties to a Takaful contract from concealing any material fact either at the point of inception of the contract or upon the occurrence of an event leading to claim. Although Takaful involves the payment of a "donation" as opposed to a conventional premium, it does not appear that any of the essential elements of an insurance contract (including the doctrine of utmost good faith) are inconsistent with the Shariah principles governing Takaful. As such, it is likely that Takaful will have all the essential hallmarks of a contract of insurance for the purposes of English law.

It is a criminal offence to carry on a regulated activity without being authorised by the FSA which is punishable by imprisonment for up to two years and/or a fine[5]. Furthermore, any agreement entered into in contravention of the requirement to be authorised will not be enforceable against the other party. As a consequence, the other party will be able to recover any money or other property paid or transferred by him under the relevant agreement.

The FSA's statutory objectives are to maintain confidence in the financial system; to increase public understanding of the financial system; to secure appropriate consumer protection and to reduce financial crime[6]. In considering an application for authorisation, the FSA will carry out a risk assessment against these statutory objectives. The risk assessment is a high level desk-top review which involves identifying business and control risks as well as external risks. In addition, there are a number of threshold conditions which are required to be satisfied. These are considered further below.

1. Examples of exempt persons include an appointed representative or a recognised investment exchange (Section 19 of FSMA).
2. Articles 3 and 75 FSMA (Regulated Activities) Order 2001.
3. Carter v Boehm (1766).
4. Joel v Law Union and Crown Insurance (1908) 2 KB 863.
5. Section 23 of FSMA.
6. Section 2 of FSMA.

Conduct of Business

The Insurance Conduct of Business rules ("ICOB") seek to carry out the high level obligations set out in the FSA's Principles for Business. Any applicant for authorisation, including those seeking to operate Takaful businesses, therefore needs to ensure compliance with ICOB. These principles impose obligations (amongst other things) to:

(i) observe proper standards of market conduct;
(ii) observe high standards of integrity and deal with consumers fairly;
(iii) act with due skill, care and diligence;
(iv) maintain adequate resources to run the business in an orderly manner;
(v) ensure that appropriate management, systems and controls are in place in relation to the size and complexity of the operation;
(vi) ensure transparency and deal with the FSA in an open and cooperative manner; and
(vii) disclose to the FSA anything relating to the firm that the FSA would reasonably expect to be disclosed.

Since these overarching rules are consistent with Shariah principles, compliance with ICOB will not pose an undue burden for Takaful operations.

Capital Adequacy

In order to meet the FSA's capital adequacy threshold, the Takaful operator must have sufficient financial resources to meet claims as they fall due. In particular, a solvency margin should be determined and agreed with the FSA[7]. This margin represents the excess of assets over liabilities and provides a useful protection against any unexpected claims. Under the Wakala and Mudarabah and mixed models, any initial capital adequacy concerns will need to be addressed, possibly through the shareholders of the Takaful operator's paid up capital, cash reserves or paid up earnings.

The FSA rules relating to admissibility of assets must be applied in calculating the Takaful operator's solvency margin[8]. These rules prescribe how much of the value of an asset (if any) can be included in the calculation of the asset for the purpose of determining the solvency margin, taking into account the permitted exposure for an asset and the maximum exposure to particular counterparties. These rules are designed to encourage a sufficient spread of assets. Although the Islamic investment market is growing at a considerable rate, the scope for investment is still more limited for Takaful operators. As a result, care must be taken to ensure that the FSA's technical solvency margins can be satisfied.

Management, systems and controls

The Takaful operator must have adequate human resources in order to effect competent and prudent management. Responsibility must be taken for managing the various legal, regulatory, underwriting, credit and liquidity risks involved in the Takaful operation. Individuals who occupy certain so-called "controlled functions" must also be "fit and proper" (i.e. they must be an "approved person" which broadly requires them to be honest and have the appropriate level of competence and capability[9]). Furthermore, individuals must have sufficient expertise in areas such as legal, accounting and underwriting matters.

Senior management must be accountable and will be held responsible for the running of the Takaful company. The FSA will require Takaful operators to maintain a clear and appropriate apportionment of significant responsibilities amongst directors and senior management in such a way that it is clear who is responsible for what in order that the business and affairs of the firm can be adequately monitored and controlled[10].

7. Pursuant to the Interim Prudential Sourcebook: Insurers.
8. Integrated Prudential Sourcebook - PRU 2 Annex 1 Admissible Assets in Insurance.
9. Statement of Principle and Code of Practice for Approved Persons - APER 2.1.
10. Senior Management Arrangements, Systems and Controls - SYSC 2.1.

An additional requirement of significant importance is the Takaful operator's systems and controls, which are in place in order to ensure that risk is managed properly. Efficient and reliable IT systems will be essential in order to process applications, handle claims and deal with general administration. It should be noted that any aspects of the Takaful business outsourced to other entities will also be examined by the FSA for their robustness.

As with all Islamic finance products, the determination of the Takaful operator's compliance with Shariah law will be the responsibility of the Shariah board, which will be made up of Islamic scholars. The Shariah board will examine all aspects of the Takaful operation and express an opinion on their acceptability under Shariah law. While it is not up to the FSA as a secular regulator to certify Shariah compliance, the FSA is likely to require a Takaful operator to demonstrate that its systems and controls are adequate in order to ensure that Shariah compliance is achieved. In this regard, the FSA may wish to be informed about matters such as the basis for appointing members of the Shariah board, the quality of information and advice available to the Shariah board and the controls over product development and over Shariah compliant investment policy and practices. The Shariah board may disagree over matters of policy and practice and, as a result, the FSA is unlikely to impose any clearly defined rules in relation to such matters. However, the FSA is likely to focus upon, and require proper governance for the nomination, appointment and operation of Shariah board members. In line with this, internal systems and controls for providing information to the Shariah board and giving effect to its rulings will need to be robust.

Disclosure

In order to become authorised by the FSA, the Takaful operator will be required to submit a business or strategy plan. This is critical in order for the FSA to have a clear picture of the nature of the operation in question, to understand the particular risks involved and how these are to be managed. Following authorisation, the Takaful operator will be required to submit a number of reports to the FSA on a regular basis, including a financial report[11]. The operator will also need to be co-operative and open in its dealings with the FSA both at the time of submission of its application and following authorisation[12].

The FSA may require the Takaful operator to provide express written notice to potential shareholders of any intention to depend on the shareholder's paid up capital or other funds due to the shareholders for the purposes of capital adequacy. For instance, a reference in the Memorandum and Articles of Association of the Takaful operator that distributable funds may be retained to provide capital adequacy to participants may not be deemed sufficient. Furthermore, any Wakala fee that is due to the Takaful operator as well as any profit sharing that may occur under the Mudarabah model, will need to be disclosed to the participants both under the principles of English common law and for regulatory purposes.

Passporting

Pursuant to the European Third Non-Life Directive[13] and Consolidated Life Directives[14], insurers are able to set up a branch in another European Economic Area ("EEA") state or to do business there on a cross-border basis subject to satisfying the conditions of the insurance directives. These are commonly referred to as "passporting" rights and they can be exercised after notification to the local insurance regulator.

11. Supervision - SUP 16.3 and SUP 16.7.
12. Principles - PRIN 2.1 (Principle 11) and Supervision - SUP 16.3.
13. 92/49/EEC.
14. 2002/83/EC.

In seeking authorisation to set up a Takaful operation, careful consideration should be given to which EU regulator would be the preferred "home regulator". The following are amongst a number of factors which should be taken into account by the Takaful operator:

(i) the regulatory hurdles to be overcome;
(ii) the administrative burden in seeking authorisation;
(iii) the on-going management supervision obligations;
(iv) the costs involved on submission of an application for authorisation and on-going periodic costs arising in meeting the regulatory requirements;
(v) the capital requirements and solvency margins;
(vi) any specific provisions relating to investment (for example, the characterisation of the Shariah compliant investment funds in which a Takaful operator might propose to invest will require some analysis to establish whether these meet any diversification requirements);
(vii) reserving requirements;
(viii) attitudes to reinsurance, including whether there is a concentrated risk exposure and the nature of the reinsurance in terms of quality and creditworthiness;
(ix) the knowledge and attitude of the "home regulator" to Takaful and related Islamic finance products; and
(x) the willingness of the "home regulator" to accommodate any particular changes that are needed to the regulatory system to reflect Takaful principles.

In light of the above, a Takaful operator wishing to take advantage of the commercial benefits of passporting will wish to consider carefully to which "home regulator" it will make its application for authorisation.

Conclusion

An increasing number of Takaful products are likely to be offered in the near to medium-term future in the UK. Takaful could be offered either as a niche product by a newly FSA authorised specialist operator or as a complementary product to conventional insurance (perhaps on the back of the provision of an Islamic mortgage) by an insurer that is already FSA authorised. On a more general note, the development of an Islamic capital and investment market will be critical to the corresponding development of Takaful. This will increase investment opportunities for Takaful operations, enabling them to maximise returns within the parameters of Shariah law. The greater availability of capital may also assist the development of a re-Takaful market in the UK and beyond.

If you would like more information on ICMIF and its services to the takaful sector, please contact Sabbir Patel (*sabbir@icmif.org*), or visit *www.takaful.coop*.