International Takaful Report 2012 – 2013

Shariah and Legal Analysis

Editorial Authors
Bilal Khan | Badrul Hasan

Laporan Takaful Antarabangsa 2012 – 2013

تقرير التكافل الدولي ٢٠١٢ - ٢٠١٣

Rapport International sur le Takaful 2012 – 2013

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Analisa Syariah dan Perundangan

Pengarang Editorial:
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Analyse du Charia et Juridique

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Bilal is a Director at Dome Advisory and is both a Shariah scholar and an Islamic finance lawyer. He received the 'Young Takaful Scholar of the Year' award at the 2012 International Takaful Summit and the 'Zaki Badawi Shariah Scholar of the Year' award at the 2011 London Sukuk Summit and has been nominated by the Securities Commission Malaysia as the 2012-2013 Oxford Visiting Fellow of Islamic Finance. Bilal is a core member of the global Working Group of leading Takaful and Retakaful CEOs as well as various bodies and international think tanks of industry leaders.

Bilal specialises in structuring and drafting authentic Shariah-compliant products in the medium of Arabic, English and Urdu. He has lectured on the undergraduate law programme at the Leeds Metropolitan University as well as on the Arabic and Urdu programmes at the University of Leeds. Bilal regularly contributes in industry journals and magazines and is quoted by electronic and press media.

Bilal is a traditionally trained Shariah Scholar of Islamic Sciences, having completed the Dars Nizami program. He has studied with many senior traditional scholars including the much revered Justice (R) Sheikh Taqi Usmani at Darul Uloom Karachi, Pakistan. Bilal read law with LLB (Hons) at the University of Leeds and completed his Legal Practice Course at BPP Law School. He completed an MA in Islamic Banking, Finance and Management with Distinction at the University of Gloucestershire and has completed an MBA in Legal Services at BPP Business School.

Bilal regularly conducts specialist executive training programs and bespoke in-house workshops. He frequently chairs and speaks at international conferences, summits and round-tables.

Badrul Hasan

Badr is a Director at Dome Advisory and is both a Shariah scholar and an Islamic finance lawyer. He is a Solicitor of the Senior Courts of England and Wales and was called to the English bar in 2001. Badr was formerly an Associate in the award winning Islamic finance team at the international law firm, Simmons & Simmons, based in Dubai. He is a Certified Shariah Advisor and Auditor with the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain and is a core member of the global Working Group of leading Takaful and Retakaful CEOs. Badr has over 10 years of experience in English law, Islamic law and Islamic finance and specialises in structuring and drafting authentic Shariah compliant financial products in both English and Arabic.

Badr has contributed to a textbook on Islamic Banking and finance called "Islamic Banking and Finance: What It Is and What It Could Be", March 2010, Published by 1st Ethical Charitable Trust.

Badr read law with LLB (Hons) at the London School of Economics after which he studied BA Shariah (Hons) at Al-Azhar University in addition to various traditional Shariah disciplines, including fiqh and usul al-fiqh (Islamic jurisprudence), with some of the leading scholars of Syria.

Badr has worked with major Islamic finance institutions including Dubai Islamic Bank and the Saudi Binladin Group on the SAR3.15bn (US$840m) development of the women's campus of King Saud University in Riyadh, Saudi Arabia (winner of "Syndicated Deal of the Year" at the Islamic Finance News Awards 2009 and "Best Social Development Deal in EMEA" at the EMEA Finance Achievement Awards 2009).

Message from Launch Sponsor

I am honoured to present this first edition of the International Takaful Report to participants at the sixth International Takaful Summit in London and to the global insurance industry at large. This is the first report in the industry that provides a wide ranging analysis of key Shariah, legal and regulatory issues in Takaful and Retakaful across various jurisdictions.

The editorial authors have brought together their knowledge of both Shariah and English common law and a high profile set of contributors from leading international law firms to fill a long existing lacuna in the industry. I understand that this Report is an executive summary of the forthcoming "Legal Practitioners' Guide to Islamic Insurance and Reinsurance", which will be a legal treatise on Islamic, common and civil laws of insurance and reinsurance, with contributions from leading international scholars and lawyers.

We have been organising the International Takaful Summit for the last six years to identify the potential issues that will affect the Takaful and Retakaful sector and bring together global players in the industry to identify the issues and debate solutions that will drive the industry forward. This Report will be an essential reference point and tool for lawyers and practitioners when facing different challenges in the coming years, particularly with the predicted spate of mergers and acquisitions brought about by sustained growth and increased competition amidst turbulent conditions in the Takaful and Retakaful industry.

M Iqbal Asaria CBE
International Takaful Summit

21 Sha'ban 1433
11 July 2012

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Feroz Agad
Chairman, SAH Global

21 Sha’ban 1433
11 July 2012

Preface

I take great pleasure in introducing this Report which boasts contribution from leading English Shariah scholars and lawyers. I understand it to be a precursor to a full legal treatise entitled Legal Practitioners' Guide to Islamic Insurance and Reinsurance.

This Report concerns Islamic insurance and reinsurance which is based on a mutual model and is of course subject to Shariah principles. The fast growth of Islamic insurance and reinsurance business worldwide has given rise to debate as to how the regulation of global insurance business can be holistic and at the same time sensitive to both Islamic and non-Islamic insurance models. Islamic insurance also brings with it an extra layer of governance relating to Islamic legal supervision which brings the interaction and overlap between Islamic laws and other legal systems to the fore. Islamic law is increasingly featuring in arbitration and dispute resolution forums enriching the legal landscape with a welter of cross-border jurisprudence that cuts across legal systems.

It is very appropriate that this Report is being launched in London. London has long been home to a whole range of highly-skilled insurance and reinsurance professionals from brokers and underwriters to a raft of supporting professionals such as accountants, lawyers and others. These people have always been open-minded and innovative, following the business wherever it is.

I welcome this important initiative by the editorial authors from Dome and wish it every possible success.

Ian Hunter QC
Essex Court Chambers
London

28 June 2012

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Editorial

Islamic financial institutions and products, like their non-Islamic counterparts, are essentially legal constructions. While there are many market reports and industry updates that provide valuable commercial information, a thorough appreciation of the Shariah and regulatory architecture that governs financial institutions and products that populate the market is an essential prerequisite to building strong and legally robust Islamic financial industries.

The Takaful and Retakaful industry is at a critical juncture where it needs guidance (Hidaya) based on authentic understanding and application of the Shariah jurisprudence and conceptual framework of the doctrines of mutuality and true risk sharing that underpin Takaful and Retakaful. On the basis of this conceptual paradigm, the industry needs to continue to develop Islamic financial jurisprudence and institutions that embody the true spirit of Takaful and the Maqasid (objectives) of the Shariah. For example, we discuss in this Report the potential for the industry to harness the friendly society and mutual models that have enjoyed long-standing success in the UK and Europe and which represent a much simpler Shariah compliant structure than the common Takaful models in use today. The problem of raising sufficient capital might be resolved by bolting on a Shariah compliant business to an existing friendly society either in addition to, or in substitution for, its existing non-Islamic insurance business. There is a favourable regulatory and fiscal treatment in the UK for friendly societies which make them attractive vehicles to introduce Takaful in the UK in an authentic manner.

Pioneering projects such as the above are long overdue, especially since friendly societies and mutuals share many of the virtues espoused by the Shariah and are part of the same ethical tradition of environmental and social stewardship as well as cooperation and solidarity between individuals and communities. This is an opportunity for the industry to present the true essence of Islamic finance and extend its arm in solidarity to offer comprehensive and paradigm-shifting solutions to the vicious cycle of modern day economic crises.

This Report is a step in the right direction. While it seeks to be thorough and accurate in its description of the existing regulatory landscape and the letter of the law, it is also a humble attempt to infuse the industry with the spirit and aspiration of the Shariah.

Bilal Khan
Director
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Badrul Hasan
Director
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21 Sha’ban 1433
11 July 2012

Chapter 1

Legal and Regulatory Considerations for Establishing Takaful and Retakaful Operations in the GCC

Rationale

While the GCC is fertile territory for Takaful and Retakaful, operators are faced with a range of challenges. The legal and regulatory landscape in the region is highly fragmented with no single set of laws and regulations applicable to Takaful and Retakaful and no passporting concept similar to that which exists in the European Union to enable an entity licensed in one GCC state to operate in another GCC state. It is therefore necessary for providers to comply with the regulatory requirements of each individual GCC state. This can create significant challenges for Takaful and Retakaful operators to achieve sufficient scale in order to have the necessary critical mass to be competitive with their secular counterparts. The capitalisation requirements and associated costs and expenses in establishing and licensing an operator in each individual GCC state can be a significant deterrent to the establishment of a regional Takaful or Retakaful operation.

This chapter addresses some of the legal and regulatory considerations facing Takaful and Retakaful operators when deciding how best to enter one or more of the GCC markets.

Non-admitted Takaful Operations

In general, 'non-admitted' business, that is to say without establishing and licensing an operation, is not permitted by the local regulators in the GCC. However, there are notable exceptions to this rule, particularly in the context of Retakaful. This may encourage operators to focus on the Retakaful sector and/or to use 'fronting' arrangements to access local markets through partnering arrangements with local Takaful operators. The concept of Financial Interest coverage may also be available for operators seeking to underwrite risks for multinational clients.

In practice, enforcement of the laws and regulations by the applicable insurance regulators is variable and therefore it is inevitable that a volume of 'non-admitted' insurance business is undertaken irrespective of any prohibitions to the contrary.

UAE	Qatar	KSA	Bahrain	Oman	Kuwait
Non-admitted insurance is prohibited by Articles 24(1) and 26 of Federal Law No. 6 of 2007. No exceptions apply.	Non-Admitted insurance is prohibited by Article 44 of Decree No. 1 of 1966. Exceptions apply other than for insurances of governmental entities.	Non-admitted insurance is prohibited by Article 1 of the law of Cooperative Insurance Companies 2003. An exception applies for risks that cannot be insured locally.	Non-admitted insurance is prohibited by the Central Bank of Bahrain ("CBB") Rulebook section AU 1.1.1. Some exceptions apply, including in respect of risks that cannot be insured locally.	Non-admitted insurance is prohibited by Article 57 of Decree 12/79. In theory an exception applies for individual life insurance. However, this exception is not utilised in practice.	Non-admitted insurance is prohibited by Article 50 of the Insurance Law No. 24 of 1961. No exceptions apply.

United Arab Emirates

Article 24 of Federal Law No. 6 of 2007 (the "UAE Insurance Law") states:
"Insurance and reinsurance business may only be carried out by … persons that are duly licensed by and registered with the [UAE Insurance Authority]." [1]

Further, Article 26 of the UAE Insurance Law provides:
"Insurance may not be arranged from outside the State for funds or properties located in the State or liabilities arising therein. Only insurance companies registered in accordance with the provisions of this Law shall be entitled to mediate in the insurance of such property or liabilities. The Insurer may reinsure a contract of insurance inside the State and outside the State." [2]

Based upon a strict interpretation of the English translation of Article 26(1), it would appear that life insurance and family Takaful risks may not be within the ambit of the prohibition. This is on the basis that the risk in a life insurance coverage is neither a "fund", a "property" nor a "liability arising therein". However, this language is interpreted by the UAE Insurance Authority as being sufficiently broad enough to encompass all classes of risks.

In practice, enforcement by the Insurance Authority of the restrictions imposed by Articles 24 and 26 of the Insurance Law has been, at best, inconsistent. For example, there have been "no objection letters" issued by the UAE Central Bank that purport to permit certain individual banks to distribute life insurance products of foreign insurers in the UAE. The legal standing of such no objection letters is uncertain and, in any event, it is unlikely that this status quo will be permitted to continue.

Any insurance contract concluded by a Takaful operator in breach of the above provisions is deemed null and void from inception and the participant may claim for damages on the ground of such nullification.[3] In addition, an unlicensed insurer or Takaful operator could be fined up to UAE 1,000,000 (c.USD 300,000) by the UAE Insurance Authority.[4]

Notes
1. Federal Law No. 6 of 2007, Article 24.
2. Federal Law No. 6 of 2007, Article 26(1).
3. Federal Law No. 6 of 2007, Article 24(4).
4. Federal Law No. 6 of 2007, Article 100.

Kingdom of Saudi Arabia

In the Kingdom of Saudi Arabia, the Law on Supervision of Cooperative Insurance Companies (the "Saudi Insurance Law") issued on 23 August 2003 provides that no company is allowed to conduct insurance business in the Kingdom of Saudi Arabia by issuing or renewing insurance policies unless it has first obtained a license from the insurance regulator, the Saudi Arabian Monetary Authority ("SAMA"). This is set out in Article 1 of the Saudi Insurance Law which provides:

"Insurance in the Kingdom of Saudi Arabia shall be undertaken by insurance companies registered therein and operating in the cooperative insurance style… and in a manner which does not contradict the dictates of Islamic Sharia."

This is subject to an exception where there is insufficient local capacity, provided that SAMA approval is sought. This exception is considered further below.

Bahrain

In Bahrain the position is similar to that in the Kingdom of Saudi Arabia. The requirements for insurers and Takaful operators to be authorised are set out in the CBB Rulebook. Section AU 1.1.1 provides that:

"No person may:

(a) Undertake (or hold themselves out to undertake) regulated insurance services, by way of business, within or from the Kingdom of Bahrain unless duly licensed by the CBB; or

(b) Hold themselves out to be licensed by the CBB unless they have as a matter of fact been so licensed."

For these purposes "regulated insurance services" are any of the activities specified in CBB Rulebook section AU-1.4, carried on by way of business. Pursuant to CBB Rulebook AU-1.4.7, the carrying on of insurance business includes the carrying out and effecting of insurance contracts as principal, including with limitation contracts of long-term insurance or contracts of general insurance. Effecting contracts of insurance means assuming (as principal) insurance risk, by entering into a contract of insurance or contract of reinsurance. Carrying out contracts of insurance means performing (as principal) obligations under a contract of insurance or reinsurance.

There is an exception where a product is not available from a licensed Bahraini insurer and the CBB's prior approval is sought.

Oman

Article 57 of the Insurance Companies Law (issued by Royal Decree 12 / 1979) (the "Omani Insurance Law") provides that insurance contracts may not be concluded with an insurance company or broker or agent unless they are registered in Oman.

This is subject to an exception for individual life insurance.

Kuwait

Article 50 of the Insurance Law No. 24 of 1961 (the "Kuwait Insurance Law") states:

"no person shall be allowed to insure directly, outside Kuwait, any real estate or property existing in Kuwait."

Although this restriction would not appear to prevent foreign insurers writing policies in respect of risks other than concerning "real estate or property", in practice the Kuwaiti Regulator has interpreted it as applying to all classes of insurance and Takaful business.

Exceptions

Exception 1 – Qatar

Article 44 of Decree Law No. 1 of 1966 (the "Qatar Insurance Law") provides:
"Natural or corporate persons may not purchase insurance as to their property/assets located in Qatar. Assets or real property situated in Qatar should be insured by national insurers."

This provision may be interpreted as allowing insurance in respect of subject matters other than "property/assets" to be underwritten on a non-admitted basis. In practice non-admitted insurance is more widespread with the above restriction applying primarily to governmental risks for which only local insurers and Takaful operators are permitted to tender.

The use of non-admitted insurance arises because

1. insurance legislation in Qatar remains comparatively undeveloped; and
2. the Qatar Financial Center ("QFC") directly regulates those brokers offering insurance products provided by insurers from other jurisdictions.

That being said, it is clear from the Qatar Insurance Law that insurers seeking to execute agreements and provide services in Qatar will be considered to be doing local business and will need to be licensed accordingly. Conversely, it appears to be generally acceptable to utilise QFC regulated intermediaries for the purposes of advising customers and arranging investments or effecting contracts of non-admitted insurance.

Exception 2 – Specific Classes of Business

Kingdom of Saudi Arabia

Risks may be placed with external insurance companies exceptionally where local coverage cannot be provided. An insurance intermediary must, *"Obtain written approval from SAMA prior to placing risks with foreign insurance companies to cover risks that cannot be covered through a licensed company in the Kingdom*." [1]

In practice, given the number and scale of insurance companies in the Kingdom, this exception is rarely applied and appears to be primarily limited to construction and property risks for large high value projects.

Notes
1. Insurance Intermediaries Regulation, Article 34(e).

Bahrain

CBB Rulebook section AU 1.4.1 provides that, *"upon application, the CBB may exclude one or more specific transactions from the definition of regulated insurance services."*

Such exemptions are rarely made given the number of local licensed insurers and Takaful operators and are usually only granted when a specific product is unavailable in Bahrain and it would be unreasonable to require the overseas provider to be licensed for that particular transaction.

Exclusions also apply for insurance or Takaful undertaken by a body corporate for other members of the same group (CBB Rulebook AU-1.4.4) or by an individual on behalf of another family member (CBB Rulebook-AU 1.4.6), insurance or Takaful business undertaken in the course of business which does not ordinarily count as a financial service that is (a) a necessary part of such business; and (b) is not separately remunerated (CBB Rulebook AU-1.4.5).

Exception 2 – Specific Classes of Business continued

Oman

The position in Oman differs markedly from that in Bahrain and the KSA. Rather than applying a general exception, there is a specific carve-out contained in Article 57 of the Oman Insurance Law. Which is stated not to apply to individual life insurance policies which may be executed by Omani nationals and/or residents with insurance companies, agents or brokers that are not registered in Oman. Article 57 provides:

"*Without prejudice to any international agreements and in operations* ***other than those of individual life insurance****, funds, property or projects in the Sultanate or liabilities resulting therefrom may be insured and brokerage done for insurance operations only with a company registered with the Register of Insurance Companies in the Sultanate*". (emphasis added)

Consequently, if the Takaful products offered to the Omani market fall within the scope of 'individual life insurance' (which is not defined in the legislation), in theory, the Takaful operator would not require to be licensed in Oman in order to sell the products to individuals who are Omani nationals and/or residents.

However, in practice the Capital Markets Authority ("CMA") in Oman appear to be of the view that Article 57 does not permit a foreign insurance company to sell its life insurance products in Oman without being licensed by the CMA. Further, a foreign insurance company (not licensed by the CMA) is not permitted to sell its products through an Omani registered broker, as Omani registered brokers are only permitted to sell insurance products offered by locally licensed insurance brokers.

Exception 3 – Retakaful Business

In contrast to the position in relation to direct insurance and Takaful business, almost all of the GCC states allow reinsurance or Retakaful business to be underwritten by foreign reinsurers or Retakaful operators. Thus, for example, the UAE Insurance Law provides that an *"Insurer may reinsure a contract of insurance inside the State and outside the State."* [1] Depending upon the business model of the operator, it may therefore be possible for an operator established elsewhere in the world to undertake Retakaful business in respect of Takaful risks underwritten by local operators in the GCC. The principle exceptions are the Kingdom of Saudi Arabia and Bahrain.

Notes

1. Federal Law No. 6 of 2007, Article 26(2).

Exception 3 – Retakaful Business continued

Kingdom of Saudi Arabia

A Takaful operator is required to retain at least 30% of its total premiums and at least 30% of any reinsurance or Retakaful protection purchased must be procured within the Kingdom.[1] Thus not more than 49% of a licensed Saudi Takaful operator's premium may be reinsured outside of the Kingdom. In practice, SAMA appears to assess a Takaful operator's business as a whole as opposed to on a risk by risk or portfolio basis. A Takaful operator may apply to SAMA for exception to this rule if the following requirements are satisfied:

1. The foreign reinsurer is licensed at home to write the specific class of business;
2. The foreign reinsurer's regulator provides SAMA with information about it;
3. The foreign reinsurer maintains separate records and financial statements for its dealings with the Saudi Takaful operator and provides information upon request;
4. The foreign reinsurer's financial statements for the previous fiscal year are provided to SAMA with its regulator's latest regulatory report; and
5. The foreign reinsurer has a minimum rating and obtains SAMA's approval if its home country has a sovereign debt rating below Standard & Poor's BBB.[2]

Additional restrictions apply in relation to facultative reinsurance.[3] Such reinsurance may be placed where the size of the risk exceeds the capacity of the Takaful operator's treaty or where no such treaty is in place. Where a facultative protection is sought for risks that exceed the capacity of the Takaful operator's treaty by more than 3 times, SAMA's prior approval is required. If facultative protection is required because a risk cannot be ceded to a treaty due to the premium rates not being acceptable to the reinsurers, it is necessary for the Takaful operator to produce a written report setting out the pricing basis used in order to demonstrate that the contributions are: (i) fair and adequate; (ii) not below technically accepted standards; and (iii) will not cause the Takaful operator to incur losses.[4] In addition, the report must provide details of the basis on which the contributions were calculated.[5]

Notes

1. Implementing Regulations, Article 40.
2. Implementing Regulations, Article 42 and Reinsurance Regulations, Article 16.
3. Reinsurance Regulations, Article 23
4. Reinsurance regulations, Article 46.
5. Reinsurance Regulations, Article 46.
6. CBB Rulebook RM-5.1.11

Bahrain

Although the CBB Rulebook does not contain any specific restrictions on the fronting of business, the CBB has orally advised that solvency requirements rules only allow for a ceding ratio of 50% or less. The source of this requirement is not clear but the passage of the CBB Rulebook Risk Management module ("RM") quoted below, which although it actually deals with retrocession risks, is indicative of the risks the CBB perceive are involved in fronting arrangements and of the CBB's likely approach to that issue:

"The [CBB] believes that insurance firms need to consider carefully dealing with reinsurers fronting 100% of the risks that are ceded to them. The concern is that the reinsurer ceding 100% of the risk to a retrocessionaire has little incentive to adhere to proper standards of underwriting, due to their receiving a fee, based on maximizing volume of premium, at the expense of underwriting soundness. Fronting arrangements can result in abrupt cancellation by the assuming reinsurer and sometimes refusal to pay claims because of the lack of observation of the understandings with regard to business quality that were agreed upon when the arrangement was negotiated. Consequently, insurers may have to assume risks for which they believed to have covered through a proper reinsurance arrangement, should the reinsurer no longer honour the arrangement. The [CBB] will scrutinize carefully the management by firms of the risks associated with fronting, in the course of its supervision." [6]

Apart from the solvency provisions discussed above, the CBB Rulebook places no restriction on the amount of reinsurance that can be placed with foreign reinsurers or Retakaful operators.

Exception 4 – Financial Interest Coverage

The concept of Financial Interest Cover ("FInC") was developed around 2006 to circumvent some of the issues surrounding global insurance programmes.[1] Instead of protecting a subsidiary or affiliate in a particular jurisdiction where non-admitted insurance or Takaful is prohibited, coverage is offered to the parent company in respect of its economic interest in the subsidiary or affiliate, locating the risk in the domicile of the parent company and making the loss or damage sustained by the subsidiary or affiliate only the trigger for the coverage.

FInC is not addressed in any of the insurance or Takaful laws in the GCC and is yet to be utilised by a Takaful operator in order to provide coverage for a customer with multinational operations. In this regard, the development in this area is likely to come from the international insurers with Takaful capabilities such as Munich Re, Swiss Re or Hannover Re. However, as businesses in the GCC region establish multinational operations, there may in principle be opportunities in this area for local Takaful operators to expand the scope of their Takaful protections. Whether there are any Shariah issues arising from the provisions governing the calculation of the parent company's loss remains to be seen and further scholarly discussion in this area is required.

Notes

1. See Strnad, *"International Insurance Programs – Legal Frictions and Solutions"*, International In-house Counsel Journal, Volume 2, No. 8, Summer 2009, 1263-1 for a more detailed discussion.

Establishing in the GCC

In circumstances where it is not practical for a Takaful operator to utilise one of the exceptions to non-admitted insurance, it will be necessary for it to establish and license an entity in the relevant jurisdiction in which it wishes to conduct business. In this regard, each of the jurisdictions in the GCC require that Takaful and Retakaful operators be established as an appropriately licensed corporate entity. Typically, this is as a branch of foreign company, a limited liability company or a joint stock company. The requirements are summarised in the following table:

	Corporate Entity	Capitalisation	Foreign Ownership Restrictions	Other considerations
UAE	Public Joint Stock Company or Branch of a Foreign Company	AED100 million (direct business) or AED250 million (Retakaful business)	Yes	Composite insurance is to be discontinued shortly. Emiritisation requirements apply (initially 10% of the workforce and 5% each year thereafter). No Islamic windows.
DIFC	Limited Company or Branch of Foreign Company	US$10 million but capitalisation requirements likely to be waived for a branch depending on the jurisdiction of the mother company	No	Generally only Retakaful not direct business. Islamic window is a possibility. No Emiratisation requirements
Qatar	Joint Stock Company or Branch of a Foreign Company	QR40 million	Yes	No Islamic windows.
QFC	Limited Company or Branch of Foreign Company	US$10 million (direct business) and US$20 million (Retakaful business)	No	Composite insurance is permitted in limited circumstances. No Islamic windows. No Qatarisation requirements at present.
KSA	Public Joint Stock Company	SR100 million (direct business) or SR200 million (Retakaful business)	Yes	Must operate on a cooperative basis (possible to offer Takaful products). Saudisation requirements will apply (typically commencing at 30% of the workforce and 5% annually thereafter).
Bahrain	Joint Stock Company or Branch of a Foreign Company	US$26 million	No	Composite insurers not permitted. No Islamic windows.
Oman	Joint Stock Company or Branch of Foreign Company	RO2.5 million	Yes	Omanisation requirements apply (typically 35% of the workforce)
Kuwait	Joint Stock Company or Branch	KWD5 million	Yes	Composite insurance is permitted. Islamic windows may be possible. Kuwaitisation requirements will apply (15% of workforce)

Alternative methods of entry into the GCC

The rate of growth of the insurance and Takaful industry in the GCC has led to certain regulators proactively discouraging new entrants into the market. In the UAE, the Insurance Authority placed a moratorium on applications to establish new insurance and Takaful companies in late 2008. Although SAMA has not explicitly imposed a similar moratorium, it is understood that it is now encouraging applicants to consider acquisitions of existing insurers. These restrictions have led to foreign entities seeking alternative ways to enter the UAE market. These alternatives are considered briefly in the following section.

Acquisitions

Acquisitions have been used as a means of entry into the GCC market without having to establish and licence a new insurer or Takaful operator. A recent example was the 2010 acquisition of Compagnie Libanaise D'Assurances in order to benefit from its branch licenses in the UAE, Kuwait and Oman.

There are regulatory hurdles to be addressed during the course of an acquisition. Whilst it is necessary to obtain regulatory approval for an acquisition, the limited level of activity in the space means that comparatively little legislative attention has been given to the subject. By way of illustration, the UAE Insurance Law contains only 3 articles that govern the acquisition of an insurance company. It is therefore an area in which it is submitted that further consideration by regional regulators is required.

There are also commercial considerations impacting upon the decision to acquire an existing GCC Takaful operator. Many of the Takaful operators are relatively newly established and it may therefore be difficult to accurately assess the value of such businesses and obtain meaningful due diligence in order to satisfactorily make a decision to undertake an acquisition.

Fronting Arrangements

In view of the general absence of restrictions on reinsurance/Retakaful arrangements, one mechanism commonly utilised is to establish partnering arrangements with a local insurer or Takaful company based upon a "fronting" reinsurance/Retakaful arrangement. Such structures are more involved than ordinary reinsurance/Retakaful arrangements in that they will typically involve the Retakaful operator providing a suite of services for the local insurer. This will typically include product development, provision of underwriting and claims advice, outsourcing of back office functions, licensing of intellectual property rights etc.

There would appear to be scope to utilise similar structures in the other GCC territories subject to compliance with local laws and regulations. In the Kingdom of Saudi Arabia, for example, it will be necessary to satisfy the requirements of the Reinsurance Regulations and the Outsourcing Regulations.

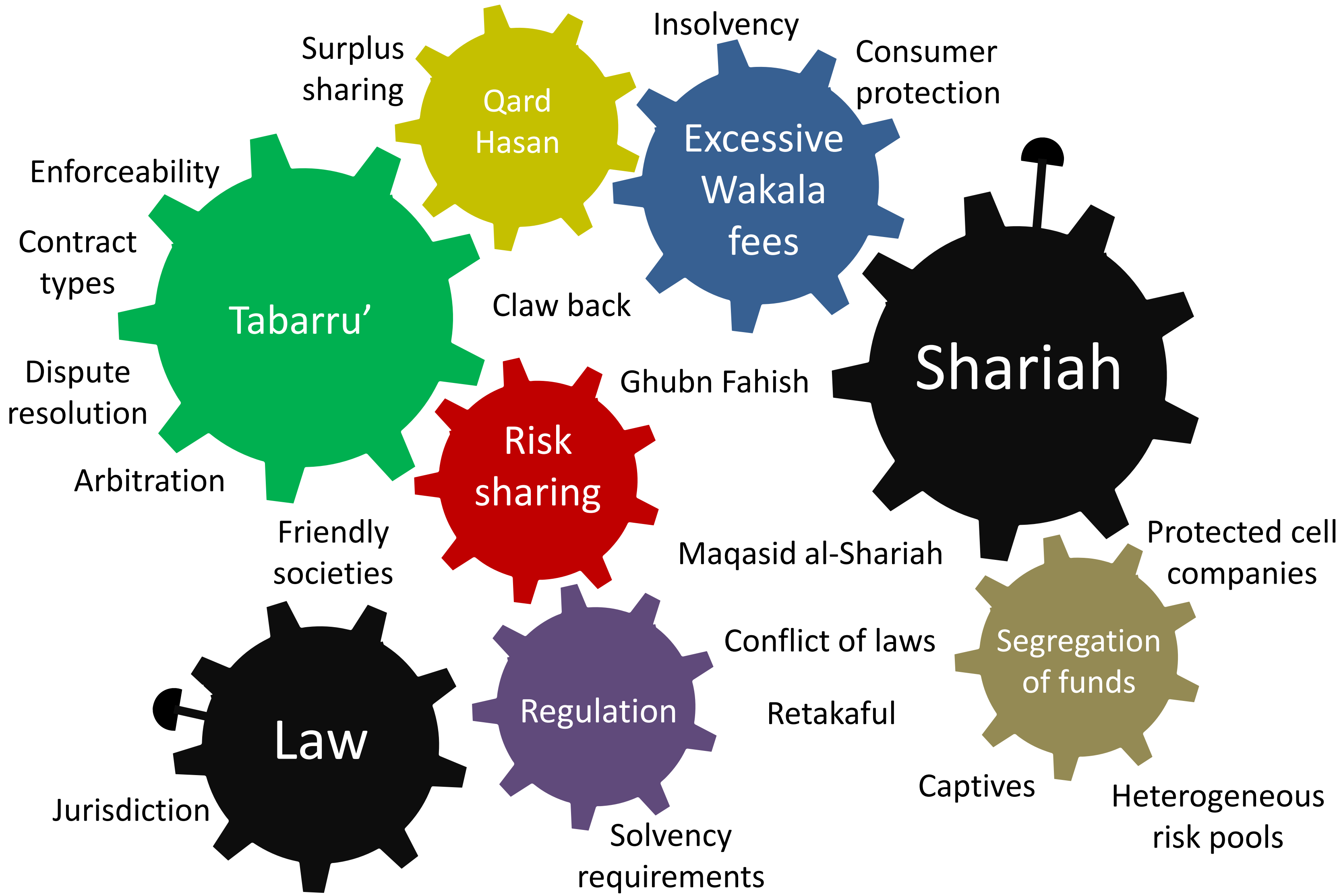
Islamic Windows

The use of Islamic windows by secular insurance companies has proven to be controversial in the GCC (as is the case elsewhere in the world). To the extent that such windows are addressed in the laws and regulations of the GCC states, there does not yet appear to be a clear consensus on the issue although the trend appears to be against the use of such Islamic windows.

UAE	DIFC	Bahrain	Qatar
In the UAE, the Takaful Regulations[1] expressly prohibit secular insurers from offering Takaful products via an Islamic window. Thus by Article 3: *"The Takaful insurance activities shall be exclusively exercised by the Takaful insurance companies. However, insurance companies may not exercise Takaful insurance activities whether directly through creating an internal entity or indirectly through an insurance agent or broker."*	The position in the DIFC is far less clear. The DFSA rulebook's Islamic Finance Rules (IFR) module (and the DFSA Rulebook as a whole) does not categorically state that Islamic windows are not permitted in the DIFC. Indeed, specific reference is made to the concept of Islamic windows in the IFR at section 3.8.3, although it is unclear whether this reference is intended to apply to Financial Services other than reinsurance/Retakaful. Published commentary by officials of the DIFC refer to the issues arising from the conflict of interests inherent in an Islamic Retakaful window.[2] By implication it appears that regulatory approval for an Islamic Retakaful window is unlikely to be forthcoming from the DFSA in the absence of a compelling regulatory business plan detailing how such conflicts are to be resolved.	The position in Bahrain is similar. The Takaful/Retakaful module of the CBB rulebook (TA) provides at section TA-2.1.2: *"…Insurance firms must operate on either conventional insurance principles or on Takaful principles, they cannot combine the two."*	The position is Qatar is, arguably, even more uncertain. The QFCRA Insurance Business Rules (PINS) explicitly describe a Takaful operator as including a convention insurer that operates via an Islamic window.[3] However, in February 2011 the Qatar Central Bank issued a circular noting that it had issued *"directives to each of the conventional banks that have Islamic branches directing them to stop opening new Islamic branches, accepting Islamic deposits and dispensing new Islamic finance operations."* [4] From 31 December 2011, such operations are to be in run off or the Islamic portfolio transferred to a licensed Islamic bank. It is submitted therefore that it is highly unlikely that the QFC will permit Islamic windows to be established for Takaful business in the future.

Notes
1. UAE Insurance Authority Board Resolution No. 4 of 2010.
2. P Casey, 'The Regulation of Takaful in the Dubai International Financial Centre', an essay extracted from S Jaffer, 'Islamic Insurance Trends, Opportunities and the Future of Takaful' (Euromoney Publications, 2007).
3. QFCRA Insurance Business Rules 1.2.7.
4. http://www.qcb.gov.qa/Arabic/News/Documents/IslamicbranchesofCommercialBank_En_PR.pdf

Core Cogs



Surplus sharing
Qard Hasan
Insolvency
Consumer protection
Excessive Wakala fees
Enforceability
Contract types
Tabarru’
Claw back
Dispute resolution
Arbitration
Ghubn Fahish
Shariah
Risk sharing
Friendly societies
Maqasid al-Shariah
Protected cell companies
Segregation of funds
Conflict of laws
Law
Regulation
Retakaful
Jurisdiction
Captives
Heterogeneous risk pools
Solvency requirements

Chapter 2

Shariah Governance for Retakaful Operators in the GCC

Rationale

Takaful operators are subject to the same corporate governance requirements as secular insurers. However, Takaful operators have an additional layer of governance in order to ensure that they operate in accordance with the requirements of Shariah. As a matter of market practice, Takaful operators tend to apply the guidance provided by the Accounting and Auditing Organisation for Islamic Financial Institutions ("AAOIFI"). This guidance is to some degree incorporated or supplemented with additional requirements by the Takaful laws and regulations in some of the GCC states. The following chapter considers the application of the laws and regulations in these areas.

Shariah Oversight by Regulators

In general, insurance regulators in the GCC do not purport to review the Shariah compliance of Takaful operators. In an exception to this trend, the UAE has enacted the Takaful Regulations[1] which include provision for the establishment of a Supreme Committee for Fatwa and Shariah Supervision (the "Supreme Committee"). At the time of writing, the Supreme Committee has not been constituted, but when it is constituted it will have wide ranging powers to oversee the Shariah compliance of UAE Takaful operators, including the power to issue Fatwas on the subject of Takaful and investment that are binding upon operators.[2]

There may also be scope for Takaful operators to be liable in civil actions for breaches of Shariah. In the UAE, for example, the board of directors of a Takaful operator may be required to suspend the activities of the operator whilst rectifying breaches. Moreover, intentional violations of Shariah may give rise to legal liability.[3]

Notes
1. UAE Insurance Authority Board Resolution No. 4 of 2010.
2. UAE Insurance Authority Board Resolution No. 4 of 2010, Article 18.
3. UAE Insurance Authority Board Resolution No. 4 of 2010, Article 31.

Constitutional Documents

In the DIFC and QFC, it is mandatory for a Takaful operator's constitutional documents to state that its entire business will be conducted in accordance with Shariah.[1]

In contrast, whilst the UAE Takaful Regulations provide that Takaful operators are to be "*managed and operate in accordance with Shariah,*"[2] there is no express requirement that this be stated in the constitutional documents of the operator. However, in practice this is likely to be the case.

Notes
1. DFSA Rulebook IFR 3.2.1 and QFCRA Rulebook ISFI 4.1.1.
2. UAE Insurance Authority Board Resolution No. 4 of 2010, Article 2(1).

Policies and Procedures

The ultimate responsibility for the Shariah compliance of an operator lies with the directors and senior management of the operator (as opposed to the Shariah Supervisory Board ("SSB")).[1] It is therefore essential that appropriate policies and procedures are established and maintained in order to ensure and facilitate compliance on an ongoing basis. In this context, the SSB's role is more akin to that of an external audit insofar as they are intended to provide an independent opinion of the Shariah requirements.

There are varying levels of regulatory requirements in relation to the policies and procedures of an operator. In the UAE, for example, the only policy expressly referred to is the by-law governing the SSB.[2] In contrast, Retakaful operators in the DIFC are required to *"establish and maintain systems and controls which enable it to comply with the applicable Shariah requirements."* [3] These include an Islamic Finance Business Policy and procedures manual.[4] In Bahrain the obligation is more generally contained in the 10 Principles of Business[5] which include the overarching obligation to take *"reasonable care to ensure that affairs are manage effectively and responsibly, with appropriate management, and systems and controls in relation to the size and complexity of operations."* [6]

Notes

1. DFSA Rulebook IFR3.3.1. See also CBB Rulebook TA 2.3.2 which provides that the board of directors is ultimately accountable and responsible for the management and performance of a *Takaful* operator.
2. UAE Insurance Authority Board Resolution No. 4 of 2010, Article 20 which requires that the by-law details the procedures for the meetings of the SSB, the quorum and adoption of decisions and the relationship of the SSB with the Shari'a controller. Article 20 expressly prohibits attendance by proxy. The by-law is to be approved by the Insurance Authority.
3. DFSA Rulebook IFR 3.3.1. A similar requirement to "establish and maintain systems and controls which ensure that [an operator's] entire business operations comply with Shari'a" is also imposed by QFCRA Rulebook ISFI 5.1.1.
4. DFSA Rulebook IFR 3.4.1 provides details of the requirements of the Islamic Financial Business Policy and Procedures.
5. CBB Rulebook TA 2.2.
6. CBB Rulebook T2.2.3 and 2.3.1.

The Shariah Coordinator

The regulatory requirements in relation to the internal Shariah compliance function of a Takaful operator vary between the jurisdictions of the GCC. In the UAE, the Takaful Regulations provide that the SSB *may* request the operator's board of directors to appoint an employee to be the Shariah Coordinator for the purposes of *"auditing the company transactions under the direct supervision of the Shariah Supervisory Committee and to ensure that the Committee's recommendations and decisions are duly carried out."* [1]

In the DIFC, the IFR rules provide that the Islamic Financial Business policy and procedures manual provides details of how the compliance function is to be undertaken, including *"the process for approving those internal systems and controls which are in place to ensure not only that the Islamic Financial Business is carried out in compliance with Shariah, but that information is disseminated using an appropriate method and manner…"*. There is no direct mention of a Shariah coordinator, instead the Takaful or Retakaful operator has a discretion as to how best to structure this role through either its internal audit or internal compliance functions provided that the individuals or departments have the competency and independence to assess compliance with Shariah.[2] Internal Shariah reviews are required by the DFSA to be undertaken in accordance with AAOIFI Governance Standards for Islamic Financial Institutions ("GSIFI") No. 3.[3]

Notes

1. UAE Insurance Authority Board Resolution No. 4 of 2010, Article 16.
2. DFSA Rulebook IFR 3.74. There is an equivalent provision in the QFC (see QFCRA Rulebook ISFI 6.3.4)
3. DFSA rulebook IFR 3.7.3. There is an equivalent provision in the QFC (see QFCRA Rulebook ISFI 6.3.3)

Shariah Supervisory Board

Takaful operators are required to have a SSB[1] commonly constituted of at least three members[2] which is mandatory requirement in some jurisdictions, such as the UAE.[3]

In the DIFC and the QFC an operator is expressly required to establish and maintain an Islamic Financial Business policy and procedures manual addressing[4] the SSB's oversight and advice, recording, disseminating and implementing Fatwas, rulings and guidelines, dispute resolution between the SSB and the operator and identification and resolution of conflicts of interest of the SSB.[5]

It is good practice for a Takaful operator to also have written policies regarding: SSB appointments, dismissals or changes, consideration of the suitability of the SSB members and their remuneration.[6]

Membership and powers	Annual Reports
In the UAE, SSB members will need to be approved by the Supreme Committee (once the Supreme Committee is constituted).[7] It is essential that the SSB members be independent of the operator and do not have conflicts of interest.[8] In the UAE, the Insurance Authority has enacted legislation that seeks to address the issue of conflicts of interest by expressly providing that a member of the SSB[9] may not be a shareholder, member of the board of directors or employee of the operator[10], or a member of two SSBs[11] nor a member of the Supreme Committee. In order to fulfil its obligations it is necessary that the SSB have broad access to information and records of the company and its management and employees. It is also necessary for the SSB to be able to elevate concerns to the board of directors of the operator in the event that they are obstructed in their duties.	The SSB is required to produce an annual report to present at the annual general assembly of the operator. The report should address a summary of the work undertaken by the SSB and its conclusions on the Shariah compliance of the operator. Typically such annual reports should comply with the AAOIFI GSIFI No. 1.[12] A copy of this report is often required to be submitted to the applicable insurance regulator.

Notes

1. See, for example, DFSA Rulebook IFR 3.4.1 and CBB Rulebook TA 2.3.3.
2. See, for example, DFSA Rulebook 3.5.1(a) and QFCRA Rulebook ISFI 6.1.1 (B)(i).
3. UAE Insurance Authority Board Resolution No. 4 of 2010, Article 10(1).
4. DFSA Rulebook IFR 3.4.1 and QFC Rulebook ISFI 5.2.1.
5. DFSA Rulebook IFR 3.5.4.
6. Such policies are mandatory in the DIFC (see DFSA Rulebook IFR 3.5.2) and the QFC (see QFCRA Rulebook ISFI 6.1.3) and the actual assessments and terms of engagement must be retained for a period of 6 years (DFSA Rulebook IFR 3.5.3 and QFCRA Rulebook ISFI 6.1.3).
7. UAE Insurance Authority Board Resolution No. 4 of 2010, Article 10(B). In the DIFC and the QFC, the DFSA and the QFCRA expressly reserve the right to request information regarding the qualifications, skills and expertise of a member of the SSB (see DFSA Rulebook IFR 3.5.5 and QFCRA Rulebook ISIF 6.1.6).
8. QFCRA Rulebook ISFI 6.1.5.
9. UAE Insurance Authority Board Resolution No. 4 of 2010, Article 11.
10. In the QFC the restriction on the SSB members is more limited. QFCRA Rulebook 6.1.1(B)(iv) requires simply that the members not be directors or controllers of the operator.
11. It is unclear whether this is limited to membership of SSBs of Takaful operators or all Islamic financial institutions or whether appointments outside of the UAE are also prohibited.
12. In the DIFC and QFC, compliance with the AAOIFI GSIFI No. 2 is mandatory (see DFSA Rulebook IFR 3.6.2 and QFCRA Rulebook ISFI 6.2.2).

Chapter 3

Country Case Study:
Analysis of Oman's draft Takaful and Retakaful Regulations

Rationale

Following a number of announcements by His Majesty Sultan Qaboos bin Said Al Said welcoming Islamic finance to the Sultanate of Oman, the Capital Markets Authority ("CMA") intends to pave the way for Takaful and Retakaful to be offered in Oman by introducing a new regulatory regime for Takaful and Retakaful. This process is currently ongoing and this overview provides a high-level summary of the current position of the CMA. As the laws, regulations and amendments in question have yet to be implemented in Oman, the position described below may be different to the position finally adopted.

Background

The CMA has jurisdiction for supervision of the conduct of insurance business[1] and the Insurance Companies Law[2] established the framework for the CMA's regulation of insurance companies in Oman. The CMA will similarly be tasked with regulating the Takaful and Retakaful industry in Oman. Due to the difference between the operations of a Takaful undertaking and a secular insurer, the CMA has determined it would be very difficult to simply extend and adapt the existing insurance laws and regulations for Takaful providers. Instead, the CMA is of the view that a new and separate regulatory framework for Takaful providers (closely based on the existing framework for secular insurers, but amended and supplemented where relevant) would be created.

This new framework is proposed to include:

> a new Takaful Undertakings Law and accompanying Takaful Undertakings Regulations, which are similar in structure and form to the existing framework for secular insurance. Takaful and Retakaful operators are not, therefore, subject to the requirements of the Insurance Companies Law or the Insurance Companies Regulations. Similarly, the provisions of the Motor Insurance Law and the Motor Insurance Regulations are disapplied for Takaful undertakings;

> amendments to Ministerial Decision No. 101/90 dated 15/1/1990 regarding the Regulation Organizing Brokers Profession;

> amendments to the Code of Corporate Governance for Insurance Companies. As Takaful undertakings are established using a hybrid structure (i.e., the Takaful fund operates in a manner similar to a mutual society, whereas the Takaful operator takes the form of a proprietary entity), the amendments made reflect this difference in legal structure and are based on the Islamic Financial Services Board ("IFSB") guiding principles on governance for Takaful undertakings; and

> amendments to Circular No. 2/2005 regarding the Code of Conduct for Insurance Business (with amendments broadly following the provisions of the IAIS Insurance Core Principles (ICP 24 to ICP 26)).

Notes

1. Pursuant to Royal Decree No. 90/2004
2. Issued by Royal Decree 12/1979

Authorisation requirements

In accordance with the provisions of Royal Decree No. 4/1974 regarding commercial companies, Takaful undertakings are required to be established as public joint stock companies with the object to conduct Takaful business and constitutional documents stating that their entire business will be conducted in accordance with the principles of Shariah. The CMA acknowledges that, in the first instance, it will be difficult for a Takaful undertaking to undertake a public offer of its shares. Therefore, a grace period for listing is currently under consideration.

Foreign Takaful undertakings will be impeded by foreign ownership restrictions from undertaking Takaful business and will only be able to provide services through a locally licensed agent in the Sultanate.

Shariah Supervisory Board

The business operations and products of a Takaful operator are required to be approved by an appropriately qualified Shariah Supervisory Board ("SSB") appointed by the Takaful operator in accordance with provisions set out in legislation.

Requirements in respect of the size, composition and appointment of the SSB are contained in the Takaful Undertakings Regulations which broadly follows the SSB requirements imposed by the Central Bank of Oman (the "CBO") on Islamic banks so that Islamic financial activity is regulated consistently across financial sectors.

At this stage, the CMA is not proposing to institute an industry level SSB, being cautious to act as the arbiters of Shariahcompliance. Rather it is concerned with ensuring the solvency and stability of any Takaful or Retakaful pools and equal treatment of consumers. However, it is proposed that legislation include a power to establish an industry level SSB should this direction be taken in the future.

Corporate Governance

The CMA has made amendments to the Code of Corporate Governance for Insurance Companies to include the specificities of Takaful Undertakings which takes on board the IFSB Guiding Principles on Governance for Takaful (Islamic insurance) Undertakings, which are as follows:

- A comprehensive governance framework defining and preserving the independence and integrity of each organ of governance and clearly setting out the mechanisms for proper control and management of conflict of interest;
- An appropriate code of ethics and conduct for officials at all levels;
- An appropriate governance structure representing the rights and interests of participants;
- Procedures for appropriate disclosures to participants;
- Appropriate mechanisms to sustain solvency; and
- A sound investment strategy and prudent management of assets and liabilities.

To ensure better compliance with corporate governance requirements in Oman, the CMA has determined that some of the key corporate governance measures be elevated to legal obligations under the Takaful Undertakings Regulations, including SSB arrangements and Shariah audits.

Conduct of business

The CMA is proposing amendments to Circular No. 2/2005 regarding the Code of Conduct for Insurance Business including, where required, amendments to Ministerial Decision No. 101/90 dated 15/1/1990 regarding the Regulation Organizing Brokers Profession, which broadly follows the provisions of the IAIS Insurance Core Principles, which covers:

> ICP 24 Intermediaries: Intermediaries are directly supervised in Oman as their conduct affects consumer protection and public confidence. In relation to Takaful, the essential criteria for intermediaries should include adequate levels of knowledge of and competence in Shariah issues and their implications so as to make proper disclosures to consumers;

> ICP 25 Consumer Protection: In relation to Takaful, the essential criteria for intermediaries and insurers should include seeking information from consumers that is appropriate in order to assess their insurance needs, before giving advice or concluding a contract. For a Takaful operator, this would extend to the Shariah aspect of what is covered under the policy, the costs and charges associated with Takaful as these are not immediately obvious and there should also be a requirement to explain the key differences between Takaful and secular insurance; and

> ICP 26 Information, Disclosure and Transparency: the public disclosure of reliable and timely information facilitates the understanding of consumers and other stakeholders.

Capital adequacy

The CMA's solvency requirements for Takaful operations should follow the same principles as those for secular insurers in order to ensure comparative treatment. However, identical principles do not necessarily translate into identical detailed rules and the minimum capital and solvency requirements for Takaful and Retakaful undertakings are proposed to be set out in separate Solvency Regulations.

Furthermore, international capital adequacy regulations have developed considerably recently to rectify the perceived deficiencies of traditional solvency systems by developing a risk-based capital ("RBC") solvency requirement which takes into consideration the risk profiles of individual insurers. In reviewing solvency requirements for suitability in application to Takaful undertakings, the CMA is considering adopting a RBC solvency requirement for both secular insurers and Takaful providers (as opposed to the currently utilised fixed-ratio model), which involves, among other things:

> adopting a system of insurance solvency supervision that utilises a retrospective approach and is based on a RBC model;

> exploring the option of enhancing the quality of the allowable capital of insurance firms by adopting Tier 1 and upper and lower Tier 2 Capital designations;

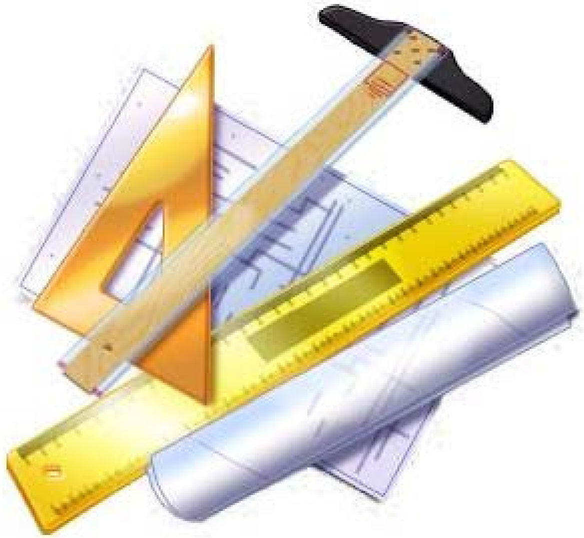
> revising the Investment of Assets Regulation with a view to adopting a hybrid of quantitative restrictions and prudent person rules; and

> reviewing the Reinsurance Strategy Circular to ensure its effectiveness in limiting the risk of large and accumulated losses for insurance companies. To limit the risk of default, the CMA is considering allowing partial deduction of the reinsurer or Retakaful operator's share from the amount of technical provision used to compute solvency requirements or make the deduction subject to certain conditions.

The RBC solvency requirements can be customised not only for the characteristics of Takaful operators as a class but also for the characteristics of individual Takaful providers.

Chapter 4

Wordings of Retakaful Contracts: Drafting Notes for Specific Clauses



Rationale

Certainty in Retakaful wordings, apart from helping to resolve disputes economically or avoid the altogether, enables the purchaser to evaluate its Retakaful asset and allows the Retakaful provider to determine the level of required reserves.

In English law, s.46 (1)(b) of the Arbitration Act 1996 allows the parties to elect to determine Retakaful disputes in accordance with Shariah principles, which removes the supervision of the court over points of law. Therefore, such Shariah principles should be expressly detailed to avoid uncertainty.

This chapter explores the effect of specific wording in Retakaful contracts, in particular provisions relating to Warranty and Conditions Precedent, disclosure and misrepresentation, Follow the Fortunes and Follow the Settlements, Claims cooperation and claims control, aggregation in any non proportional Retakaful and "boilerplate" clauses such as the Inspection, Termination, choice of law, jurisdiction and forum.

Specific Clause Wordings

Warranties

Takaful and Retakaful underwriters, like insurers and reinsurers, rely upon warranties and conditions precedents to minimise the expense burden and thereby charge relatively low amounts in premium to provide high levels of cover.

In English law and some other laws that derive from it, breach of warranty allows an insurer to void the contract even if the breach does not cause loss. This draconian power enables the insurer to enforce a condition or promise without having to perform due diligence or to monitor the insured's activities. In other countries, a breach of warranty may only operate to absolve the insurer of liability to a loss occasioned by the breach. Therefore, a Retakaful contract drafted under English law should be clear as to whether a provision is intended to operate as a warranty or not.[1] Generally speaking, the best way to do this is to use words such as "It is warranted that…". When drafting Retakaful wording where English law will not apply, it is important to consider what promises are being extracted from the party purchasing the cover and what remedies may be appropriate for breach. Those remedies should then be spelt out clearly in the wording.

Notes
1. It should be noted that the English law remedies for breach of warranty are being considered by the Law Commission and reform of these rules may occur in the near future.

Conditions Precedent

Conditions Precedent are provisions that require certain steps to be taken before a Retakaful provider becomes liable and are useful clauses to ensure the provision of information in a full and timely manner, particularly with regard to the handling of claims. If a condition is to be a condition precedent, it must be expressed as such clearly and without any ambiguity.

If, for example, it is intended that notice of a loss must be provided swiftly in order to allow the Retakaful provider to participate in the adjusting of the loss or to reserve in a proper and timely fashion, it should be stated that "It is a condition precedent to liability under this Agreement that…"

While it can be argued in some circumstances that conditions are warranties or conditions precedent without expressly saying that they are, it is always better to be abundantly clear.

Remedies

(Re)Insurance and (Re)Takaful are, under English law, contracts of utmost good faith which means that failure by the purchaser to make all material disclosures may lead to the contract being avoided from inception.[1] If however, the parties dispense with the strict remedies allowed at law and replace them with a claim for damages for breach or no recourse at all, it is necessary to express clearly what remedies are being waived and in what circumstances. A party cannot obtain the other party's agreement to waive remedies for its own fraud.

In a Retakaful agreement, thought should be given to what, if any remedies would be appropriate for non disclosure, misrepresentation or breach of warranty. These remedies should then be expressed clearly.

In English law an issue exists as to whether a misrepresentation or non disclosure is (a) material and (b) actionable as it must also have affected the mind of the actual underwriter. Evidence of the objective prudent underwriter as to materiality and the subjective actual underwriter can be complicated. This issue can be avoided if the purchaser of the Retakaful contract warrants that all necessary information has been disclosed and is accurate. The contract can then provide for the remedy for any breach of the warranty.

Clauses concerning remedies are rare and are not found in every Retakaful or reinsurance contract. It could be argued that every Retakaful contract that includes an election under s.46 (1)(b) of the Arbitration Act 1996 to subject the contract to Shariah principles requires language that establishes what must be disclosed and provides remedies for non disclosure and misrepresentation as well as breach of warranty.

Notes
1. As with the equally draconian rules for breach of warranty, these rules are being considered by the Law Commission.

Follow the Fortunes and Follow the Settlements

Follow provisions require the Retakaful provider to accept whatever settlements have been agreed by the Retakaful purchaser.

It has often been argued by a reinsurer that the claims presented fall outside of the reinsurance cover, that they fall outside the underlying cover or that they have not been properly adjusted. The contract language should determine what is to be covered and what proof of loss is to be required. To what extent will the Retakaful provider be able to open up the underlying settlement and to what extent may it be allowed to demand evidence of that settlement?

Thought should be given in proportional treaties to including a provision that absolves the ceding company from any inadvertent error or omission provided that the error or omission is corrected immediately upon discovery, thus limiting the ability of the Takaful provider seeking to repudiate the contract for such inadvertent breaches.

It is important to state clearly in what circumstances ex gratia claims, particularly in relation to catastrophe protections, will be recoverable under a Retakaful contract. The difficulty arises in that because they are ex gratia, they are not losses arising under the underlying Takaful contract.

Extra contractual obligations, punitive damages and costs of declaratory judgment actions are all examples of other claims that arise in connection with an underlying Takaful contract but not under it. In English law, these are not generally covered unless they are expressly agreed to be covered.

Claims Cooperation and Claims Control	Aggregation Provisions
Claims control allows the Retakaful provider to manage claims as if it were the underlying Takaful company. This occurs where a local risk is fronted through a Takaful company for regulatory or other reasons and the true economic interest resides with the Retakaful provider. Claims cooperation occurs more frequently when the knowledge and understanding of the Retakaful provider exceeds that of the Takaful company but the economic interests are possibly more aligned. In some cases, claims cooperation clauses directly contradict follow the settlements provisions so the contract should expressly provide for exactly what should happen when a claim is made, how it should be notified and how it is to be managed. Where appropriate, conditions precedent can be used to ensure compliance. Issues such as the recoverability of extra contractual obligations or punitive damages also require consideration in this context.	In non proportional reinsurance, the manner in which claims can be aggregated is of fundamental importance. In aggregate excess of loss covers, this is simply a matter of defining the claims that can be aggregated. In event based covers, however, the issue is considerably more complicated and the implications of different interpretations can be financially very significant. The commercial balance between frequency and severity of loss will depend on the claims scenario and the layer of Retakaful involved. A Retakaful provider may not always wish to argue for more events or for fewer and may well have its own catastrophe protections which will influence its view of a given loss. The definition of "event" is one of the most fraught areas of contract interpretation. The courts have opined that for claims to be grouped together as arising out of one event, they may share unities of time, space and intention. While this assistance from the courts is valuable, it does not easily answer every question. The use of the word "event" is sometimes supplanted by "occurrence" or "originating cause". Care should be taken to ensure that the correct word is chosen. Generally speaking, it is a sensible approach to review the underlying wordings and to adopt, where possible, the language used there to ensure that the cover is as back-to-back as possible and does not leave any gaps. It is also important, when determining what layers of excess of loss cover are required to protect a Takaful book, to establish whether the book is more likely to be subject to frequency or severity of loss and to purchase accordingly rather than seeking to stretch the meanings of words in a Retakaful contract to achieve the same result after the event.

Inspection Clauses	Termination and Insolvency Provisions
While Inspection clauses are often overlooked at the time of placing a new contract or at renewal, when problems arise, they can be very controversial so it is worth including an Inspection clause in every Retakaful treaty wording, every agency agreement and every facultative master agreement. The Inspection clause can provide for the data being made available on-line, which is generally more appropriate to proportional arrangements. A Retakaful provider denied inspection due to unpaid balances may in turn argue that it cannot be in a position to determine what it owes until it inspects. English reinsurance law cases resolve this issue by saying that the two rights, the right to be paid and the right to inspect, are independent rights and proceedings could be commenced to recover balances claimed while the inspection continues. This controversy can be avoided by a simple statement in the Inspection clause to the effect that the exercise of a right to inspection does not delay or in any way remove or reduce the obligation to pay claims. Delays caused by Takaful operators requiring Retakaful providers to sign a confidentiality agreement can be avoided by agreeing, in the body of the Inspection clause, that confidentiality will be maintained. While issues relating to the protection of legal privilege, particularly in relation to liability claims, ought not to be a problem under English law, where different claims in different jurisdictions are covered in the claims files, care should be taken by both sides to avoid a waiver of privilege as both parties have a common interest in preserving it. Again, this issue can be dealt with in the Inspection clause. Other issues that can arise and ought, ideally be covered in the Inspection clause are the identity of the inspectors or auditors, hours of access, notice, provision of copy documents and the ambit of the inspection i.e. whether inspection will cover all data relevant to the contracts or be restricted to claims files only.	The early termination of a contract is an event that is more likely than most others to give rise to a dispute so the circumstances that might give rise to early termination and what should occur after should be reflected in the contract. For example, the Retakaful provider may wish to retain the option to terminate if there is a change of control of the Takaful company, especially if the Takaful company is acquired by a rival, or if there is war between the countries of the two parties. Potential insolvency is a difficult area. First, one must define the trigger that would allow the counterparty to terminate such as downgrading by a rating agency, the nature of which ought to be carefully defined. Where the company is rated by more than one entity, a clear definition of which combinations of rating agency and what type of downgrade would trigger the right to terminate must be specified. Downgrades sometimes happen too late and so an insolvency event needs to be described as a further trigger. The contract should stipulate what should happen upon a termination such as how notice should be given, from when it will operate, what steps will be taken to manage the business already in force and how will any commutation of that business operate and on what terms.

Choice of Law, Jurisdiction and Forum

Reinsurance contracts have commonly included arbitration provisions, which has been followed to some extent in Retakaful contracts. The idea is that a determination of the meaning of a Takaful or insurance contract by others from within the industry or "Honourable Engagement" is more likely to reflect the true intentions of the parties at the time that the contract was agreed.

Facultative reinsurance, unlike treaty reinsurance, has generally sought to provide back-to-back cover and, accordingly, very often the dispute resolution provisions of the underlying insurance contract have been incorporated into the reinsurance agreement. In some instances, even in facultative reinsurance, particularly when placed under a standard form or protocol, arbitration has been the agreed form of dispute resolution.

Orion v Belfort Maats [1962] Lloyd's Rep 257	Eagle Star v Yuval [1978] 1Lloyd's Rep 357	Home & Overseas Insurance Co Ltd v Mentor Insurance Co (UK) Ltd [1990] 1 WLR 153	Czarnikow v Roth Schmidt [1992] [92 LKJB 81]
The court held that the contract was valid but the arbitration provisions were not. Despite this, Honourable Engagement clauses still appeared in most reinsurance contracts.	The position adopted by the court was a radical change. Lord Denning held that the contract and the clause were valid and that the clause simply did what commercial men had always done and that was to seek to lessen the constraints imposed on arbitrators when arriving at their decision and to allow for an interpretation of the contract in a commercial way. Denning's decision came shortly before the significant rise in reinsurance disputes that occurred in the early 1980s. At this time, the informal resolution of disputes was becoming more difficult as the sums involved became more significant. Reinsureds and reinsurers consulted lawyers who sought to advise them on their rights and liabilities. The existence of Honourable Engagement clauses made this task difficult. The arbitration clauses allowed arbitrators to apply a subjective standard to the interpretation of the wording; precedent did not appear to apply.	The court found that Honourable Engagement clauses merely allowed arbitrators to refrain from following strict rules of evidence and that they could utilise their own expertise in determining the correct commercial context from which to construe the wording. The clause did not, however, remove the law from the construction of the contracts.	The English court held that an Honourable Engagement clause was an attempt to oust the jurisdiction of the court and, as such, raised the question of whether the parties to the contract had the intention to create legal relations. Despite this, Honourable Engagement clauses remained in use until the 1960s .

With law placed once more firmly at the centre of contract interpretation, lawyers were able to use precedent to predict how arbitrators ought to determine the meaning of those contracts. Appeals from arbitral awards were frequent. Through those appeals, a body of precedent for the interpretation of reinsurance contracts was created. In 1996, new arbitration legislation was introduced in The Arbitration Act 1996 which did much to simplify the process of arbitration.

Chapter 5

Arbitration and Dispute Resolution for Takaful and Retakaful

Rationale

Takaful schemes, like any other commercial agreements, need a reliable and trusted dispute resolution process. As the risks that are covered by Takaful schemes increase in size, the potential financial significance of any disputes will increase and their impact on risk management will become stronger.

When entering into any dispute resolution process, there will be a number of aspects of risk for the parties. This chapter discusses the different situations that will arise across the industry, the extent to which the determination of Shariah principles will need to be part of the dispute resolution process and how this will impact on the appropriate forum for the determination of disputes.

Risk 1 – Governing law

In any legal system, however well developed, there will be uncertainties as to the meaning of the law that becomes evident as disputes pose questions that the law does not specifically address. In common law systems, principles may have been clarified in prior case law which forms a binding precedent in subsequent cases. In civil law systems, reference may be made to authoritative academic opinions or non-binding prior case law. In the case of Takaful, the potential application of Shariah principles in the context of an agreement governed by a secular law gives rise to increased uncertainties.

The requirement to comply with Shariah law principles may arise in a number of different ways:

Situation 1	Situation 2
The Takaful agreement is governed by a secular national law but the Takaful operator may simply want to be in a position to be able to certify to participants that the scheme is Shariah compliant, even though it is not under any regulatory or constitutional obligation to be so. It is likely that when resolving any dispute, the court or tribunal would take the view that the dispute should be determined in accordance with the agreed governing law and that principles of Shariah law are not necessarily relevant. However, it is possible that principles of Shariah law may be admitted to the extent that they constitute the factual context in which the agreement was entered into, especially if there is ambiguity in a contract and the court or tribunal is seeking to determine the common intention of the parties.	The Takaful agreement is governed by a secular national law but the Takaful operator is forbidden by law or by its constitution from entering into any non-Shariah compliant contracts. A court or tribunal would apply the agreed governing law to all questions of the interpretation and performance of the contract although Shariah principles may be relevant to the interpretation of ambiguous provisions. However, it may also be possible for the validity of the contract to be questioned on the basis that it is ultra vires for breaching Shariah law or secular law. This form of argument has been raised in English case law.[1] In these circumstances, the court or tribunal may seek expert evidence from Shariah scholars to determine Shariah compliance. Secular foreign courts or tribunals are generally reluctant to come to a decision that contradicts the opinion of the operator's own Shariah Supervisory Board that the product is Shariah compliant but this would not necessarily be the case. ------------------------ Notes 1. See Investment Dar Company K.S.C.C v Blom Developments Bank S.A.L [2009] All ER (D) 145

Situation 3	Situation 4
The Takaful agreement is governed by a secular national law but it also states that it shall be interpreted in accordance with Shariah principles. Different courts or tribunals may well take different approaches as to the emphasis that they place on Shariah principles. Secular national courts such as the English courts are likely to refuse to apply any law other than an established national law (subject to Shariah principles potentially constituting background relevant to the interpretation of ambiguous aspects of the contract). However, it is not uncommon to find arbitration clauses referring to principles of good faith, common principles of international law or several individual legal systems, Ex Aequo et Bono or religious laws. Accordingly, an arbitral tribunal would not be prevented from taking Shariah principles into account when reaching a decision even though the agreement was governed by a national law. ------------------------ Notes 1. Beximco Pharmaceuticals Ltd and others v Shamil Bank of Bahrain EC [2004] EWCA Civ 19 (28 January 2004).	The Takaful agreement is governed by a Shariah based or partially Shariah based national law and disputes could theoretically be subject to the jurisdiction of foreign courts or arbitral tribunals. Other national courts would in general seek to apply the foreign law to the resolution of the dispute provided it does not offend against public policy. In practice, the courts of the well established international legal centres such as London and New York are very accustomed to applying foreign laws. However, if a Shariah based national law is applicable, it is likely to be more practical to refer disputes to arbitrators with knowledge and experience of the Shariah.

Risk 2 – Wrong outcome

There will be the risk that the dispute resolution process comes to the wrong result. This could be because of a range of factors from the extremes of bias, political interference, or incompetence, to a lack of relevant legal experience or an inadequate dispute resolution procedure. In the context of high value Takaful agreements, international commercial parties are unlikely to have sufficient confidence in the national courts of states other than those with the most well established legal systems experienced in dealing with large commercial matters.

Western parties are unlikely to choose national courts other than those of England or perhaps New York or some other respected common law jurisdictions. Alternatively, arbitration with a seat in a jurisdiction that is respected as being “arbitration friendly” and using a well respected arbitral institution would be expected.

Risk 3 – Enforcement

There is a very significant risk that a judgment or award cannot be enforced against a Takaful or Retakaful operator, which will be a strong factor influencing the choice of dispute resolution forum. This issue is particularly pertinent since the scope for enforcing foreign awards and judgments in the Middle East, in particular, is still significantly limited by, inter alia, principles of public policy and Shariah.

There are very few international treaties and conventions applicable to the enforcement of court judgments between European or North American countries and countries in the Middle East. Accordingly, enforcement tends to depend on the application of local law rules. In practice very few foreign court judgments have been enforced in the region because of arguments regarding reciprocity (and the different approaches taken in civil and common law jurisdictions), public policy and jurisdiction.

The position regarding enforcement of international arbitration awards is better since a very large number of states (including Bahrain, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, Syria and the United Arab Emirates in the Middle East) have signed the 1958 New York Convention on the enforcement of arbitration awards. However, despite these countries being signatory to the convention, in practice, enforcement of arbitration awards in a number of Middle Eastern countries is by no means straightforward and is often refused.

Conclusion

Whatever dispute resolution forum is chosen by the parties to Takaful schemes, this will not be the only forum in which related disputes are determined. Where third parties are involved, they will not be bound by contractually agreed dispute resolution provisions and will not necessarily be concerned with Shariah principles. In particular, there will be claims by third party creditors and/or by insolvency officers against assets of Takaful and Retakaful funds. These claims will provide rigorous testing of the effectiveness of the structures adopted in implementing the Shariah principles regarding ownership of the Takaful fund in the same way that the validity of proprietary interests such as charges and trusts are tested in insolvency proceedings in other spheres of finance and commerce.

Chapter 6

Friendly Societies and Other UK Mutuals: A Vehicle for Shariah Compliant Insurance in the European Market

Rationale

Mutual insurers have existed in the UK for hundreds of years in the form of friendly societies and mutual insurance companies. Friendly societies in particular have an affinity with Shariah principles because all contributions to a friendly society are made voluntarily. Friendly societies have evolved in different ways over the years. Since 1992 most have taken advantage of the ability to incorporate which allows them to undertake a defined range of activities.

Friendly societies have traditionally been associated with serving specific geographical, occupational or religious communities. They exist in other common law jurisdictions and examples exist in Trinidad & Tobago, the Republic of Ireland and South Africa, of friendly societies that have Islamic objects.

A UK friendly society can provide a suitable vehicle for Shariah compliant life assurance (although not for general insurance, unless the business is conducted within the accident, sickness or miscellaneous financial loss classes) and represents a much simpler Shariah compliant structure than normal Takaful models, which would be consistent with the Shariah emphasis on Maqasid (objectives) and on substance rather than form.

Friendly Societies and Shariah principles

Riba (interest)	Tabarru' (voluntary contributions)	Gharar (risk trading) and Maisir (gambling)	Waqf (endowment)
Although, like other UK regulated firms, friendly societies are subject to Financial Services Authority ("FSA") rules on solvency and capital, there is no requirement for them to hold interest-bearing instruments as capital. Neither are they required to charge interest on any loans they make to members.	Friendly societies legislation requires all contributions to a society to be made voluntarily. Contributions to a Takaful fund might otherwise be characterised as contractual obligations and thus Haram but this cannot arise with contributions to a friendly society.	The voluntary nature of contributions to a friendly society which in turn makes payments to members on death or in adversity means that the payments are not speculative wagers on the occurrence of an uncertain future event.	Unlike secular insurers, one of the statutory purposes of friendly societies is to engage in social and benevolent activities alongside the benefits they provide to members. This enables them to donate surpluses to charitable causes.

Regulatory capital hurdle

There would be significant challenges in establishing a new Shariah compliant friendly society from scratch.

In order to be authorised by the FSA to carry on regulated activities in the UK the friendly society would need significant amounts of regulatory capital.

As a mutual institution, a friendly society does not have shareholders who might provide that capital. On the contrary, Section 5(2)(b)(i) of the Friendly Societies Act 1992 provides, in effect, that only members (or persons connected with members) can receive benefits from the Society and the converse of this is also generally held to be true, i.e. that a person cannot be a member of a friendly society unless he (or a person connected with him) receives insurance or similar benefits from the society.

Proposed solution

As a general rule, although there have been exceptions, friendly societies have been well capitalised – many have existed for a long time, over which surpluses have accumulated within the society.

The problem of raising sufficient capital might therefore be resolved by bolting on a Shariah compliant business to an existing friendly society either in addition to, or in substitution for, its existing secular insurance business.

The FSA would need to be convinced that any such transaction treated the existing policyholders of the friendly society fairly in order to comply with Principle 6 in the Principles for Business chapter of its Handbook. It may not be difficult to make the case that a new line of business with millions of potential customers in the UK and elsewhere in Europe, who subscribe to the combined values and ethical principles espoused by Takaful and other mutual models, would be advantageous to existing customers of a mutual society.

The single passport

An advantage of a UK friendly society as a vehicle for Shariah compliant insurance lies in the fact that it will be supervised by the FSA. Under Article 5 of the 'Directive of the European Parliament and of the Council of 5 November 2002 concerning life assurance' (2002/83EC), authorisation by the FSA is valid for the entire European Union and in fact extends also to non-EU member states which are part of the European Economic Area.

The above principle is known as the "single passport" and means not only that a UK friendly society can conduct business throughout the EEA from its base in the United Kingdom without the need for separate authorisation in each separate member state, but also that it can set up a branch or agency in another member state.

As a directive, this has to be implemented under the domestic law of each member state. Nevertheless, the general principle holds that a UK authorised friendly society, in common with other UK authorised insurers, can conduct business throughout the EEA with minimal additional formalities.

Fiscal and regulatory advantages of UK Friendly Societies

The Friendly Societies Act 1992 gave friendly societies the additional flexibility of incorporation. As such, both incorporated and registered societies automatically meet the threshold conditions for authorisation and for the grant of permissions under paragraph 1(1) of Part 1 to Schedule 6 of the Financial Services and Markets Act 2000.

In addition, friendly societies have long enjoyed some fiscal advantages. When the modern form of income tax was first introduced in 1806, friendly societies that were registered under the Friendly Societies Act 1793 were exempt from it (McLeod and Levitt, 1999) and were again exempted when income tax was re-introduced in 1842. Since then, the generalised relief has been much reduced, but still remains a valuable attribute of friendly societies. There are principally two forms of relief: in respect of life or endowment business and in respect of other business.

All registered and incorporated friendly societies are exempt from tax on life and endowment business under what is now Section 460 of the Income and Corporation Taxes Act 1988 in respect of what have come to be known as “tax exempt savings products” or “TESPs” i.e. savings plans over a term of ten years where annual contributions are limited to £270 or monthly contributions to £25. From time to time, the friendly societies movement lobbies government to increase these limits, which used to benefit from fairly regular adjustments, but the government policy in recent years has been to leave these limits alone.

The exemption for non-life and non-endowment business, which is set out in Section 461 of the Income and Corporation Taxes Act 1988, applies only to societies registered before 31 May 1973 and to more recently established societies where their business is limited to providing benefits for employees for a particular employer or other approved groups of persons.

A society which was first registered before 31 May 1973 but subsequently incorporated can continue to enjoy the exemption by virtue of Section 461A of the Income and Corporation Taxes Act 1988. Such a valuable exemption is subject to stringent anti-avoidance provisions including powers for HM Revenue & Customs to serve notice to withdraw the exemption when it considers a friendly society’s business to be on an “enlarged scale” or of a “new character”. These anti-avoidance provisions may, depending on the circumstances, operate to deny tax exemption to an established friendly society seeking to undertake Shariah compliant business, but need not necessarily do so and, in any event, the onus is on HM Revenue & Customs to invoke the anti-avoidance provisions by giving a direction to the society. There is also a right of appeal against HMRC directions.

References

1. The Association of Friendly Societies Year Book 2001-2002
2. Simon Cordery: British Friendly Societies, 1752-1914; Palgrave MacMillan, 2002
3. Liverpool Victoria Friendly Society Limited, Annual Report and accounts as at 31 December 2010
4. McLeod and Levitt, Taxation of Insurance Business, 1999

Chapter 7

Implications of Protected Cell Companies, Segregated Account Companies and Similar Entities for Takaful and Retakaful

Rationale

Problem	Solution
Risk Pooling at both Takaful and Retakaful levels is a key issue confronting the Takaful and Retakaful industry. Risk pooling at Retakaful level involves managing the risks of different Takaful companies, each with its own approach and underwriting risk appetite, resulting in divergence in each Takaful company’s contribution of underwriting surplus or deficit. Commercially, a participating Takaful company generating high surplus may not wish to share its surplus with other participating companies that may be generating losses or low surplus. In the case of deficits, the position is usually corrected with Qard from the Retakaful company. As an extreme example, if a Takaful company goes into liquidation, the Retakaful company either has to recover the Qard from other participating companies or has to write off this Qard. This is not attractive to shareholders and results in reluctance to invest in Retakaful companies leading to leakage of Takaful business to secular reinsurance companies.	While the Shariah principle of risk pooling in light of the Maqasid al-Shariah (objectives of the Shariah) is to encourage sharing of the upside and the downside, especially in relation to homogenous risk pools, the Shariah also permits the segregation of funds by business line, geographical scope etc. as long as there is risk sharing between at least two participants and the surplus is distributed based on the overall results of the fund rather than individual treaty results. Therefore, the Retakaful operator may set up various funds based on underlying risk characteristics in order to ensure that the fund results are relatively stable. In fact, the Shariah prohibition on Dhulm (unfairness) may encourage Retakaful operators to separate various funds into segregated cells, such as for example, short-term Takaful lines from long-term family Takaful lines. Arguably, surpluses can justifiably be retained to build up reserves without appropriating surpluses belonging to previous generations of contributors in long-term Takaful lines but not so much in short-term Takaful lines. This chapter explores whether, especially for more heterogeneous risk pools, it may be possible for Retakaful operators to set up Cell Companies or Cell Captives in some jurisdictions to segregate different risk categories and overcome these commercial issues while at the same time benefitting from certain regulatory, tax and cost saving advantages. It must be kept in mind however that the more funds or cells a Retakaful operator sets up the more volatile each fund or cell becomes. So, the challenge for the Retakaful industry is a commercial one: to accumulate sufficient critical mass to ensure that the various Retakaful funds or cells are sustainable.

Background

A Cell company's assets can be legally segregated between different owners. Cell companies have been developed by statutory instruments to replace the cumbersome one-off trust and contractual arrangements that were expensive and difficult to regulate.

Main jurisdictions

Guernsey was the first jurisdiction to introduce the protected cell company ("PCC") formally into statute in 1997.

Bermuda gave the segregated account company or ("SAC") statutory protection in 2000. Since then, over 30 jurisdictions have introduced either identical or fundamentally similar legislation.

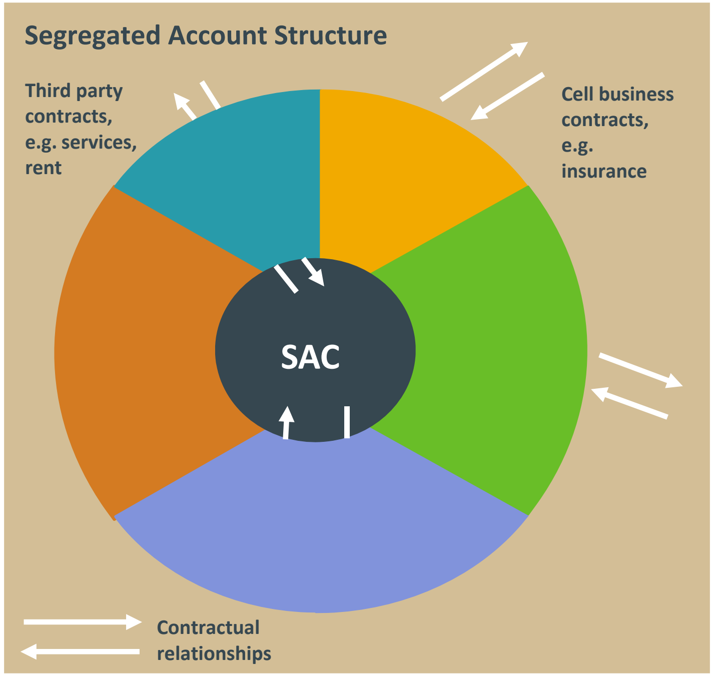
Jersey introduced the incorporated cell company ("ICC") which developed the concepts of the PCC and SAC yet further.

Segregated Account Companies

A Bermuda SAC is a single legal entity, set up by the Segregated Accounts Companies Act 2000 ("SAC Act"), requiring limited capital and governed entirely through contractual arrangements, in particular the governing instrument.[1] A SAC can only carry on business as an insurer or investment fund.[2]

SACs have a General Account or "Core" and a number of cells known as Segregated Accounts ("SAs") which may have separate owners. SA owners do not necessarily have any interest in the Core. Each SAs' assets are protected from the other SAs' liabilities, except if they contract with one another. SAs may contract only in arrangements which are envisaged under the governing instrument of the SAC. The SAC provides directors, company secretarial, administrative and accounting services. There are specialist managers who are usually appointed to run the structure. Normally, an SA will contract with the SAC for management and administrative services, and with third parties to carry out the cell's business.

Arrangements similar to SACs can be found in other jurisdictions e.g. Cayman Islands have the Segregated Portfolio Companies ("SPCs").

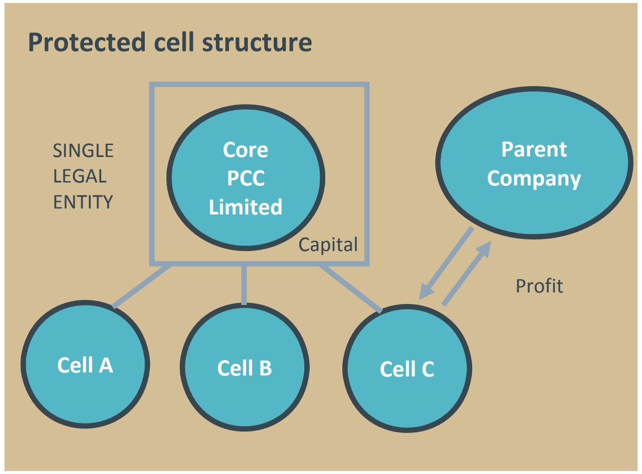


Notes

1. s.11 SAC Act
2. s.3 SAC Act

Protected Cell Companies

PCCs are single legal entities, initially developed by statutory instrument in Guernsey.[1] PCCs are constituted of a Core and a number of Protected Cell ("PCells") which may have different owners. The PCC's memorandum and articles of association essentially replicate a familiar company structure but the assets of each PCell are protected from the other PCells' liabilities, unless there is a recourse agreement between the PCells.[2] There is a contractual nexus between the PCells and the Core which provides directors, administration etc. PCells cannot contract with the Core or with each other but can contract individually with third parties.[3]

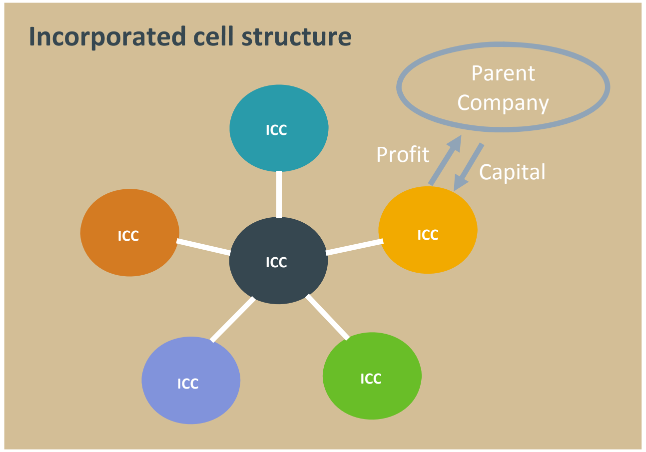


Incorporated Cell Companies

An ICC is a multi-company structure of separate legal entities with no single entity status, initially developed in Jersey but now appearing under statute elsewhere. The ICC and each ICell is a separate legal entity for regulatory purposes but together form one entity for tax purposes.[4] Each ICC and ICell has its own Memorandum and Articles of Association, directors, minutes book, share capital and accounts. ICells are permitted to trade with one another and can be individually rated. Jersey legislation[5] provided certain improvements on the Guernsey structure, namely:

> a clear ability of a cell company to create binding relationships between its cells by entering into contracts. In contrast in Guernsey, cells are not able to contract with other cells or the core but only with third parties[6]; and

> the ability of a cell to become a standalone company by incorporation.[7]



Notes

1. The Legislation is now contained in the Companies (Guernsey) Law 2008 (as amended) ("G Co Law"), in relation to Guernsey.
2. s.449-51 G Co Law
3. s.441 G CO Law
4. See for example, Companies (Jersey) Law 1991 (as amended) ("J Co Law").
5. Ibid
6. Arts 127YC & YD J Co Law
7. Art 127YH J Co Law

Advantages and Disadvantages of the PCC, SAC and ICC

	Advantages	Disadvantages
PCC / SAC	> Single legal entity with reduced administrative costs such as filing returns and accounts > Tax benefits through the multiple ownership of the cell structure	> Uncertainty as to legal segregation of each cell/account
ICC	> Not complex to understand or administer and therefore less prone to administrative error. > Robust segregation of each cell/account > Each ICell can become a standalone captive or investment entity, for example where it has amassed such capital as to allow it to fund its own operations or where one investment policy is so much more successful than others within the ICell so as to merit it becoming a separate platform/fund.	> Each cell is a separate legal entity so the ICC does not benefit from advantages of a single legal entity

Segregation of assets between core and cells

Segregation from the core is key as giving cells access to the capital of the core would increase the risk of the whole structure failing, following failure of one cell. While each new cell acting as an insurer or Takaful operator has its own regulatory capital to support its underwriting and is responsible for its own liabilities so that the core does not need to have its assets boosted, such cell may look to have recourse to the assets of the core which is usually set up with enough capital to meet basic solvency requirements for insurance operators.

To give a cell writing Takaful business access to the core while other cells write secular insurance business would be potentially dangerous and might prejudice the Shariah compliance of the Takaful cell.

Takaful models

The Wakala and Mudaraba models can be fitted to the cell company structure. The commercial logic of the Wakala model (appointing an operator remunerated by a fee) should be weighed against the undoubted advantage of an operator who has "skin in the game" under the Mudarabah model. Given the capital reform of the EU moving towards the desirability of having a professional operator with something to lose if they do not perform well or fail to monitor the business appropriately e.g. Article 135 of the Solvency II Directive and Article 117 of the Capital Resources Directive, there is much to be said for keeping some element of the Mudaraba model. The concerns which Guernsey, for example has over the use of cell companies for defrauding creditors means that the Mudaraba model may have particular strengths in the eyes of the regulators. However, current cell company managers would probably be more comfortable with being appointed agents under the Wakalah model and receiving a fee.

Takaful cell company operations

The cell company, if set up entirely in accordance with the terms of a Takaful model, would be operated so that:

- each participant would contribute funds, some to the Core and the rest to the Cell.
- the Takaful operator would run the Core and each Cell on a day to day basis, taking into account directions from the participants.
- the governing instruments that establish the Core and Cells would:
    1. if a Mudaraba model is used, state the ratio by which the profit will be shared and if a Wakala model is used, state the operator's fee;
    2. if a Wakala model is used, set out fund arrangements, where the Cells will need to be split in two, one fund for the investment activity and the other for Takaful activities;
    3. under the Wakala model, state that the investment fund within the Cell would be available to meet any shortfall in the 'Takaful' fund and that there would be no recourse to the other Cells if a Cell as whole were unable to meet claims; and
    4. allow recourse between the Cells and the Core in limited circumstances for solvency purposes. A Cell in deficit, unless due to the operator's negligence, is for the account of the relevant participant, and they would be expected to make good the losses.

Risks: Segregation and cross-border insolvency

The robustness of the segregation between cells in a cross-border insolvency has not been thoroughly tested, though it appears that the UK courts would uphold the segregation of assets and the UK legislature is in the process of introducing cell company structures for open-ended investment company arrangements which will give greater comfort in future.

Whether an English liquidator would respect the firewalls between the Cells and the Core could depend upon the circumstance in which the liquidation arose and how the cell company has been run, cf. SphinX case.[1] This may be critical in a Takaful structure where recourse arrangements to the core are operated actively and in which steps should be taken to avoid the rule as to unsecured and unpreferential creditors being able to claim pari passu treatment as this is clearly incompatible with the segregation of assets in a cell company type entity. However, creditors might logically claim that there was recourse available at least from the core in a Takaful structure which might not be the case under a non-Takaful arrangement.

The overarching risks when dealing with a cell type structure are as follows:

> the misallocation of assets amongst the SAs/cells or the general account/core; and

> the breakdown of ring-fencing amongst the SAs or cells and non-recognition of a foreign court with respect to a creditor or insolvency claim against the assets of the company.

Risk mitigation: Governance

> Any contract with a cell company should incorporate provisions that reflect the legislation clearly stating that the assets attributable to the cell concerned are only available to the creditors of the cell company who are creditors in relation to that cell and importantly, that the party contracting with the cell company shall not, in respect of the liabilities under the contract, have any right or claim against assets attributable to other cells; and

> Cell company contracts need to be made expressly subject to the law in which the cell company is established so that there is less risk of the courts of that jurisdiction failing to uphold the segregation of assets.

> One of the key requirements that any cell company type structure involving a single Takaful cell (or indeed an entire Takaful cell company) would need to meet is to follow procedures to the letter. This should substantially reduce the likelihood of challenge to the structure particularly where (as in the SphinX case) the segregation of cell assets from the core (or even from each other) seemed to have been generally ignored.

Notes

1. In Re: Refco Inc.

Case law: SPhinX

Facts

The SPhinX case involved Cayman Islands Segregated Portfolio Companies (SPCs) used for a group of connected hedge funds. The case raised issues over co-mingling of assets between cells and the legal nature of SPC cells.

The collapse of the SPhinX funds was precipitated by the collapse of US commodities broker, Refco LLC. A few days before Refco LLC filed a petition for Chapter 11 Bankruptcy, US$312 million of excess cash held for certain SPhinX cells was transferred to accounts opened by the cells with Refco LLC. In turn, the same funds were transferred by Refco LLC to accounts held by the cells at other institutions. This US$312 million transfer was later challenged by Refco LLC's creditors as an unlawful preference.

UK Legal Opinion	US Legal Opinion	Ramifications for Takaful
UK Counsel varied in their opinions, in one case advising that an SPC is effectively a trust company with each cell as a separate and discrete trust managed by the SPC as trustee. The beneficiaries of each 'trust' are not just the shareholders (investors) of the cell but also its creditors. An SPC's liquidation does not alter its trust status and the liquidators are required to manage cell assets as trust property. This "trust" opinion has been widely criticised and while the courts' ultimate conclusion is unclear, the parties have sought a practical solution to the bankruptcy. Accordingly, it is unlikely that the case can provide a reasoned judgment on the operation of cell companies, though this would be helpful.	In the meantime, the US Courts have opined (with little regard to the law of the Cayman Islands) and ignored the segregation of cells. This has been challenged by the liquidators in Cayman using the trust arguments in mounting that challenge. In particular, if cell assets are indeed trust assets and the liquidators are trustees, then there are specific trust rules that govern trusts, recovery of assets and the right of a trustee to seek costs and expenses under the trustee's indemnity.	The impact of the case is unlikely to conclude that cell companies are creatures of trust law which may be good news for Takaful operators though unattractive to liquidators. However, the 'trust' theory cannot be ignored as it provides a simple solution to the problem of co-mingling and the trust vehicle is of course the concept from which the cell company developed. Takaful operators should be aware that the US courts will not necessarily uphold the arrangements set up under another jurisdiction providing for strict segregation of assets, though it is unsurprising that the US Courts reacted as they did as the managers of the SPC in question ignored the segregation of cells in running the company. The key lesson for Takaful operators is that they should always maintain the segregation of assets and liabilities of all cells rather than merely paying lip service to it.

Impact of Solvency II

Takaful Cell Companies

The European prudential regulation of insurance companies, Solvency II, is of interest to those jurisdictions with cell companies.

Solvency II is a Risk Based Capital ("RBC") assessment and corporate governance review and provides access to the European insurance market to jurisdictions which have been granted "third country equivalence". Third country equivalence is determined by reference to the techniques that Solvency II is seeking to embed, aiming to have equally robust prudential management systems worldwide.

One of the key drivers for good risk management of Takaful companies is the need to pool risk and diversify risks. A Takaful cell company would therefore consider to what extent there is a risk pooling and diversification being conducted across the cells and the extent of this would depend on where the Takaful company is domiciled. RBC tests are used in Bermuda, while Guernsey legislation and regulations are less explicitly risk-based and it has only recently attempted to bring in a RBC assessment test. Guernsey has expressly stated that it is not seeking Solvency II equivalence.

Takaful Captives

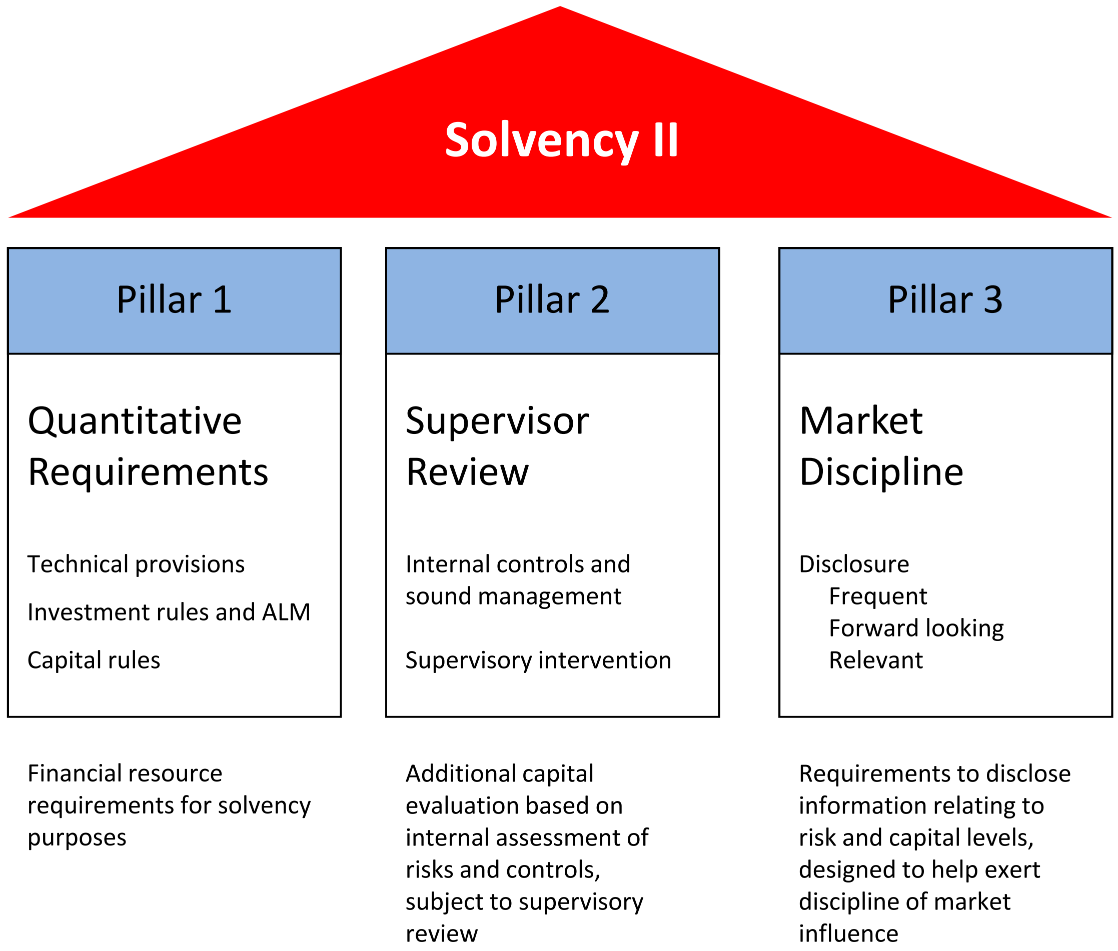
Captive insurers and (Re)Takaful operators are faced with two issues:

> the difficulties that Solvency II will bring them, in particular the extra capital required despite there being little risk inherent in the arrangements.

> the lack of diversity for a captive – while it may insure against different risks, its ultimate insured is the same person for every risk.

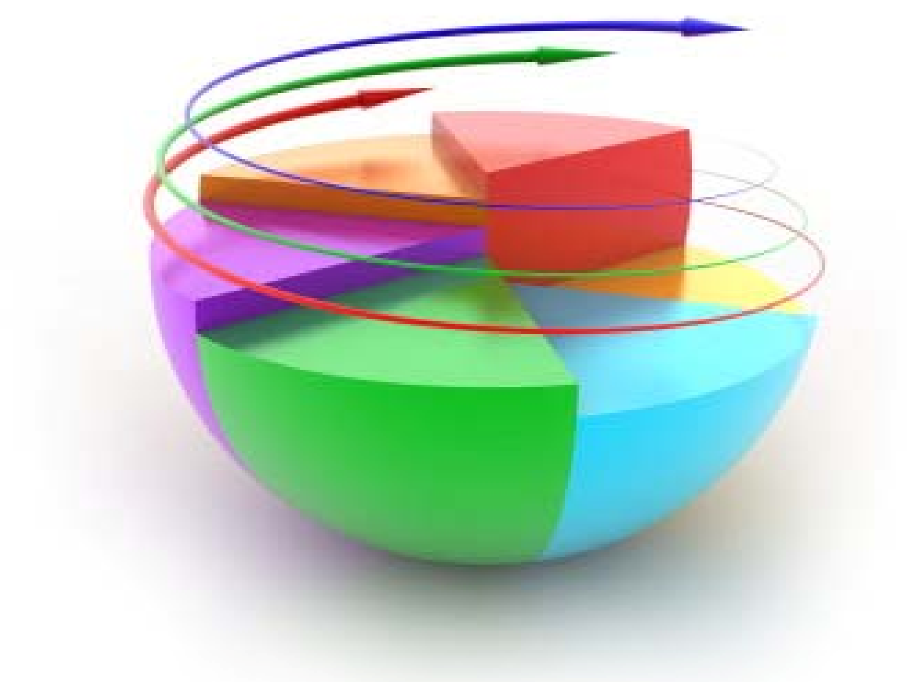
There appears to be a distinction arising between cell companies used for ordinary commercial insurance and those used as insurance or Takaful captives, the latter being perhaps seen as less risky and therefore to have less need to comply with the RBC requirements of Solvency II.

However, while cell companies used as insurance or Takaful captives (in particular rent-a-captive) will not have to concern themselves with Solvency II and hence RBC assessment and diversification, those insurance and Takaful cell companies used for a more streamlined business organisation will need to consider diversification issues and underlying risk management issues across all the cells as if they were standard companies conducting insurance. Accordingly, the corporate governance and RBC requirements applied to standard commercial insurers will apply equally to cell companies and the impact of assessing the RBC will presumably need to ignore the cell structure and report on the overall cell company as one entity.


Solvency II
Pillar 1
Quantitative Requirements
Technical provisions
Investment rules and ALM
Capital rules
Financial resource requirements for solvency purposes
Pillar 2
Supervisor Review
Internal controls and sound management
Supervisory intervention
Additional capital evaluation based on internal assessment of risks and controls, subject to supervisory review
Pillar 3
Market Discipline
Disclosure
Frequent
Forward looking
Relevant
Requirements to disclose information relating to risk and capital levels, designed to help exert discipline of market influence

Chapter 8

Implications of Solvency II and the IFSB Standards for Takaful and Retakaful



Rationale

Solvency II refers to a package of legislation that will have implications for almost all aspects of (re)insurance and (re)Takaful business in the European Economic Area ("EEA") including capital levels, systems and controls and governance. Some of the provisions of Solvency II are reflected in the standards of the Islamic Financial Services Board ("IFSB"). Solvency II is expected to take effect from 1 January 2014.

Legal Form of Solvency II

The Solvency II legislative framework consists of three levels:[1]

Level 1

The "Level 1" directive[2] provides for the repeal of the existing EU directives from which much of the current law and regulation in member states that applies to (re)insurers is derived.[3]

Level 2

In time, EU regulations or directives, referred to as "Level 2" measures, will set out detailed requirements in numerous areas in which the Level 1 directive stated only a high level rule or general principle. Unlike a directive, the Level 2 measures will have direct legal effect in the laws of every member state so it will not be strictly necessary for national law to implement any Level 2 measures. It is therefore expected that Solvency II will achieve a greater amount of harmonisation of insurance law and regulation throughout the EEA than has been achieved by previous directives.

Level 3

The Level 1 directive and Level 2 measures will be accompanied by guidance to be given by the European Insurance and Occupational Pensions Authority (EIOPA), referred to as "Level 3" guidance.

Notes

1. The terms "Level 1", "Level 2" and "Level 3" refer to components of the Lamfalussy process by which EU legislation is developed. The process also includes a "Level 4", which is the enforcement process.
2. Directive 2009/138/EC.
3. These directives include the Consolidated Life Assurance Directive, the three Non-Life Insurance Directives, the Reinsurance Directive, the Insurance Groups Directive and the Insurers Winding-up Directive. Note that the Insurance Mediation Directive is not replaced by Solvency II.

Key Issues arising from Solvency II

Solvency II can be usefully divided into four categories:

Category 1: Capital Requirements

Solvency Capital Requirement ("SCR")
SCR is intended to be risk-sensitive so that capital held is proportionate to the amount of risk to which it is subject. SCR is determined according to a broad range of risks to which the (re)insurer or (re)Takaful entity will be subject in order to ensure that it has a probability of remaining solvent over a one year period of at least 99.5%.[1]

Minimum Capital Requirement ("MCR")
MCR will set a lower minimum level of capital, which if breached, gives the supervisor the power to prevent the insurer from continuing its business by prohibiting the free disposal of its assets.[5]

Own Funds
An important question is what capital or "own funds" will be eligible to cover the SCR. Eligible capital includes the excess of assets over liabilities and subordinated liabilities. This issue is of special interest to (re)Takaful entities given their limited ability to raise capital by methods that are available to other (re)insurers, and special consideration is needed when considering the Qard as capital.

SCR Risks
The risks covered by the SCR will include underwriting risk, market risk, counterparty default risk and operational risk, each of which is to be measured with very great granularity in one of two ways.

Own Risk and Solvency Assessment ("ORSA")
To supplement the SCR, insurers will be required to produce an ORSA for review by their supervisors[2] to identify any risks not reflected in the SCR. The ORSA may be the basis for the supervisor deciding to use its powers to impose an "add-on" to the SCR.[3]

Recovery Plan
Where a (re)insurer or (re)Takaful entity does not comply with its SCR (as supplemented by any applicable add-on), it will be required to submit a recovery plan to its supervisor within two months and provide progress reports thereafter, but other than in exceptional circumstances the supervisor will not prevent it from continuing its business.[4]

Standard Formula
A detailed "standard formula" to be set out in the Level 2 measures.

Internal Model
An approved internal computer model.

Notes
1. See Recital 64 and Article 101(3).
2. Article 45.
3. Article 37.
4. Article 138.
5. Article 139.

Category 2: Requirements that restate the existing directives in largely identical terms

Solvency II maintains the core principles relating to insurance authorisation, supervision and passporting within the EEA.

Passporting	Financial supervision	Objects	Separation of general and family	Portfolio transfers
New (re)Takaful entities with authorisation within a member state[1] can provide services across borders[2] and establish branches[3] without requiring further authorisation. -------------- 1. Article 14(1). 2. Article 15 and 147. 3. Article 15 and 145.	Supervision of assets, liabilities and capital levels will continue to be the responsibility of the home state supervisor.[4] ---------- 4. Article 30.	(Re)insurers are still limited to "the business of insurance and operations arising therefrom, to the exclusion of all other commercial business".[5] This requirement has been interpreted differently and future Level 3 guidance may result in greater harmonisation of the interpretation. -------------- 5. Article 18(1)(a).	An entity cannot carry on both general and family (re)Takaful business (with the exception of accident and sickness insurance).[6] -------------- 6. Article 73(1). The classes of non-life insurance and life insurance are listed in Annex I and Annex II respectively of the Level 1 directive.	Change of control and portfolio transfers continue to be recognised[7] subject to prior supervisor consent.[8] On a winding-up, direct policyholders will continue to have priority over cedants and other creditors, except where they constitute rights *in rem*.[9] -------------- 7. Article 39. 8. Article 57. 9. Article 275.

Category 3: Requirements that change existing detail

Significant changes will be made to reporting requirements such as a single reporting format across the EEA[1] and the requirement to produce an ORSA and a publicly disclosed solvency and financial condition report. [2]

However, Solvency II will make investment requirements less restrictive, with general freedom of investment,[3] subject to complying with the "prudent person principle" [4] and subject to exceptions for investments in securitisations[5] and assets covering linked liabilities, where national supervisors will have discretion to continue to impose restrictions.[6]

Category 4: Requirements not forming part of existing directives

There are a number of new concepts in Solvency II:

> In relation to regulatory capital, the treatment of ring-fenced funds[7] and the use of an internal model to calculate capital requirements.[8]

> Detailed governance requirements.[9]

> Detailed requirements for the use of outsourcing.[10]

Notes
1. Article 35.
2. Article 51.
3. Article 133.
4. Article 132.
5. Article 135.
6. Article 133(3). The FSA has said that it will exercise this discretion to continue to impose restrictions for linked business in the UK: see "CP11/23: Solvency II and linked long-term insurance business", October 2011.
7. Article 99(b) and Article 111(1)(h).
8. Article 112.
9. Article 40 et seq.
10. Article 49.

Extra-territorial effect of Solvency II

Equivalence

Solvency II will give a number of advantages to non-EEA insurers who are in "equivalent" jurisdictions. At the time of writing, Bermuda and Switzerland are being considered for an equivalency determination for all three of the above purposes, and Japan is being considered in relation to the treatment of reinsurance. Other key jurisdictions such as the USA may be subject to transitional provisions until they undergo full equivalence determination.

External relationships

Solvency II will affect external relationships of EEA (re)insurers and re(Takaful) entities in three key ways.

Group solvency requirement	Group-level supervision	Treatment of Retakaful
The financial position of other members of a (re)insurer's or (re)Takaful operator's group will be taken into account irrespective of where those other group members are located,[1] either for purposes of Solvency II standards or their "equivalent".	EEA (re)insurers or (re)Takaful entities will be subject to group-level supervision covering not only group solvency but also intra-group transactions and governance.[2] Groups that are owned by non-EEA parent companies will be subject to supervision by an EEA supervisor at the level of the ultimate parent company unless it is determined that they are subject to equivalent supervision by local regulators.	An EEA insurer or Takaful entity may be subject to less favourable treatment, such as being required by its regulator to obtain pledging of assets from reinsurers/Retakaful operators, if it purchases reinsurance or Retakaful outside the EEA or an equivalent jurisdiction.[3]
------------------------ 1. Article 218.	------------------------ 2. Article 213.	------------------------ 3. Article 173.

Issues of special relevance to (re)Takaful entities

(Re)Takaful Entities authorised as insurers or reinsurers in the EEA will be subject to Solvency II as well as the requirements of Islamic law and potentially the IFSB Standard on Solvency Requirements for Takaful (Islamic Insurance) Undertakings. The combination of these requirements raises two important issues – the treatment of ring-fenced funds and the treatment of the Qard.

Issue 1: Ring-fenced funds

(Re)Takaful entities are required to keep separate the shareholders' fund and the participants' fund(s). Under Solvency II, if the separation results in a restriction on free movement of capital between these funds, the funds are treated as "ring-fenced funds" preventing losses suffered in one fund being covered by transferring surplus assets from another, as such assets must be held exclusively for the benefit of the participants, and an adjustment is made to the SCR in respect of each fund.[1]

Although the SCR calculation may be done on an individual fund basis, it is an entity level requirement and each ring-fenced fund would not require capitalisation to meet its notional SCR. In theory, an unlimited amount of capital could be held in the shareholders' fund to cover the entity level SCR. This differs from the position in the Standard on Solvency Requirements for Takaful Undertakings published by the IFSB, which requires that "of the shareholders' funds, only the amount of the Qard facility may be counted as capital in assessing the solvency of a [participants' fund]".[2]

Any capital in each ring-fenced fund that exceeds its notional SCR would be deducted, preventing the entity from taking credit for surpluses in one fund against deficits in another. This treatment would be consistent with the IFSB Standard on Solvency Requirements for Takaful (Islamic Insurance) Undertakings.[3]

Notes

1. Article 99(b).
2. Article 18(1)(a).
3. See para 49.

Issue 2: The Qard

The Qard, though not strictly speaking necessary for a (re)Takaful operation, is an interest free loan provided by the shareholder fund (or operator fund) to a participants' fund if there is a shortfall, to be repaid when it can do so without falling below a specified financial position. The Qard is held in the shareholders' fund until it is drawn down and transferred to the participants' fund. The Qard requires separate analysis of the treatment of each fund, both before and after drawdown.

Before drawdown	After drawdown
Before the Qard is drawn down, the assets covering it in the shareholders' fund should represent a surplus over the liabilities of the (re)Takaful entity (measured at overall entity level), and this surplus should be eligible as part of the (re)Takaful entity's Tier 1 capital. Since the Qard is freely transferable into the participants' fund, this capital will not need to be deducted from the total capital of the entity. Should the Qard be treated as capital of the participants' fund before it is drawn down? For purposes of Solvency II, this is not strictly relevant, as it would not affect the notional SCR of the fund. In any event, it would be double counting if it were treated both as capital of the shareholders' fund and capital in the participants' fund.	A drawn down Qard will increase the assets of the Participants' fund and if invested in assets, they may increase the notional SCR of the fund on the basis of the market risk associated with the assets. Would any liability to make repayment to the shareholders' fund have to be recognised? There are three possibilities: > no liability is recognised (valuation at zero); > a subordinated liability is recognised; or > a full liability is recognised. It is not clear which of these would apply and how it would impact the entity level capital position – valuation at zero would seem to be the appropriate treatment, but it is difficult to see how this treatment is justified by application of the rules on the valuation of liabilities. If the terms of the Qard do not oblige the participants' fund to make repayment of the Qard in the event of a surplus in the fund – for example, by making repayment conditional upon the fund being in surplus by a given amount or percentage above its notional SCR, the excess surplus might be considered to be subject to restrictions on transferability, resulting in its being deducted from the capital at entity level. The above analysis applies where the shareholders' fund and the participants' fund are parts of a single legal entity. If the Qard were a facility made by a legal entity separate from the authorised (re)Takaful entity, then several important changes would apply to the analysis, and the Qard is likely only to achieve treatment as Tier 2 capital.

Analysis of the IFSB Standards

There are two IFSB standards that are of most relevance to the areas covered by Solvency II:

1. the Standard on Solvency Requirements for Takaful (Islamic Insurance) Undertakings, published in December 2010 (the "IFSB Solvency Standard"); and
2. the Guiding Principles on Governance for Takaful (Islamic Insurance) Undertakings (the "IFSB Governance Standard").

The IFSB Solvency Standard	The IFSB Governance Standard
The IFSB Solvency Standard does not set capital requirements but focuses on the structure of a solvency regime that can accommodate the special arrangements of (re)Takaful entities. It has a number of features consistent with Solvency II. For example, among other things,: > it advocates that the prudent person principle should apply if quantitative restrictions to the assets held by a (re)Takaful entity are not applied;[1] > it suggests that a market consistent approach to the valuation of assets and liabilities should be used.[2] > it contains provisions on the assessment of the quality of capital, in particular the need for availability, permanency and absence of encumbrances and mandatory servicing costs;[3] > it requires that a solvency analysis should be carried out at the level of each participants' fund, but it goes further than Solvency II by requiring that capital necessary to support the fund should actually be held in the fund, with the sole exception of the Qard.[4] Moreover, it requires that the undrawn Qard should be "earmarked" within the shareholders' fund;[5] and > it remarks on the importance of adjusting the amount of solvency resources "to take account of the non-transferability of solvency resources between ring-fenced funds".[6] It does not refer to the calculation of a notional capital requirement in the absence of any diversification between the funds, though this may be implicit. The IFSB Solvency Standard contains a detailed analysis of the requirements necessary for the Qard to operate effectively such as the need for the (re)Takaful entity to give consent to the supervisory authority to treat the drawn down Qard as capital belonging to the participants' fund in order to meet participants' claims.[7] The concept of giving consent to the supervisor is not used in Solvency II.	The IFSB Governance Standard lays down a number of core principles, covering the need for a comprehensive governance framework, a code of ethics for officials, procedures for appropriate disclosures, mechanisms to sustain solvency and a sound investment strategy. Solvency II focuses on the ultimate responsibility of the governing body, the need for an effective system of governance, fit and proper requirements for officials, effective risk management, internal control, internal audit, the actuarial function and outsourcing.[8] ----------------------- 1. See para 25 and cf Article 132. 2. See oara 23 and cf Article 75. 3. See para 49 and cf Article 93(2). 4. See para 28. 5. See para 34. 6. See para 39. 7. See para 52. 8. Articles 40, 41, 42, 44, 46, 47 and 48.

Acronyms

AAOIFI	Accounting and Auditing Organisation for Islamic Finance Institutions
CBB	Central Bank of Bahrain
CBO	Central Bank of Oman
CMA	The Capital Markets Authority of Oman
DFSA	Dubai Financial Services Authority of the DIFC
DIFC	Dubai International Financial Centre
EEA	European Economic Area
FSA	Financial Services Authority of the UK
GCC	Gulf Cooperation Council
GSIFI	Governance Standards for Islamic Financial Institutions of AAOIFI
IFR	Islamic Finance Rules of the DFSA's rulebook
IFSB	Islamic Financial Services Board
KSA	Kingdom of Saudi Arabia
RBC	Risk-based capital
SAMA	Saudi Arabian Monetary Authority
SSB	Shariah Supervisory Board
UAE	United Arab Emirates

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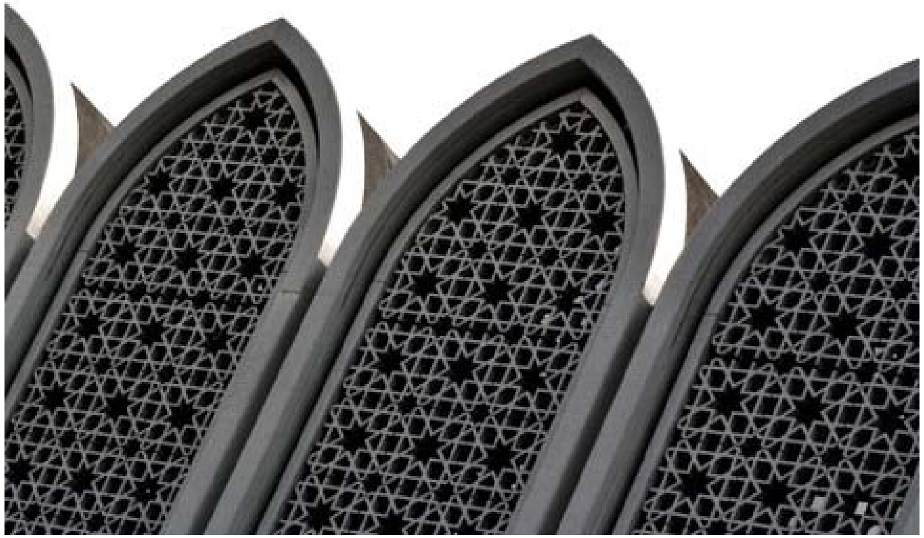

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